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IN THE

# Supreme Court of the United States

October Term, 1972

No. .....

THOMAS C. MAY, as Intervenor on behalf of Custom Component Switches, Inc.,

*Petitioner,*

*vs.*

ALLEN V. C. DAVIS, CUSTOM COMPONENT SWITCHES, INC., MARVIN GOODSON, WILLIAM E. HANNAM, GLEN A. BERRY, DON GRIFFITH, CAL CASEY, and ROBERT MILLER,

*Respondents.*

## VOLUME I.

**Petition for a Writ of Certiorari to the Court of Appeal of the State of California, Second Appellate District.**

**Volume Containing Opinion of Court Below Bound Separately.**

Thomas C. May, as Intervenor on behalf of Custom Component Switches, Inc., hereby petitions for a Writ of Certiorari to review the decision of the Court of Appeal of the State of California for the Second Appellate District.

### Citation to Proceedings Below.

The opinion of the Court of Appeal of the State of California, Second Appellate District, was certified for

nonpublication. The opinion is lengthy, and accordingly is set forth in a separate volume which accompanies this petition.

**Jurisdiction.**

The opinion of the Court of Appeal of the State of California, Second Appellate District, was entered on May 23, 1972.

A timely Petition for Rehearing was filed with the Court of Appeal on June 7, 1972, and was summarily denied on June 20, 1972. The order denying the petition for rehearing is set forth in Appendix A.

A Petition for Hearing in the Supreme Court of the State of California was filed on July 3, 1972, and was denied by that Court on July 19, 1972. The order of the California Supreme Court is set forth in Appendix B.

Jurisdiction to review the proceedings in the court below is conferred on this Court by Title 28, United States Code §1257(3).

**Questions Presented for Review.**

The following questions are presented for review by this Court:

1. Can California refuse to hear an assignee's challenge to the validity of its assignor's patent on the ground that the assignee lacks "standing" to do so where (i) the assignee has received technical and business assistance from its assignor, and (ii) the assignment was part of a plan used by the assignor to solve certain of his business and tax problems?

2. Where an inventor has obtained a patent by fraud on the patent office, can California assist him in collecting royalties on that patent by interpreting, or reforming the agreement with his assignee?

## Constitutional and Statutory Provisions.

This case involves the following constitutional and statutory provisions:

1. Article I, §8, Cl. 8, of the Constitution of the United States, which provides in part as follows:

> "Congress shall have power . . . To promote the Progress of Science and Useful Arts by securing for limited Times to Authors and Investors the exclusive Right to their respective Writings and Discoveries."

2. Article VI of the Constitution of the United States, which provides, in part as follows:

> "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby . . . ."

3. Title 35, United States Code §§102(a), 102(b), 102(e), and §103, which are set forth in Appendix C.

## Statement of the Case.

Respondent Allen V. C. Davis is an inventor. Prior to 1957 he had filed patent applications on three devices—a pressure switch, a fuel proportioner, and a torque spring. These devices were manufactured and sold by his wholly-owned Hydra-Electric Corporations (Hydra).

In 1957 his lawyers, respondents Marvin Goodson and William E. Hannam, devised a plan (referred to in this litigation as the "Custom Plan") to counteract the danger that Hydra's profits would be subject to renegotiation. In addition, this plan would enable

Davis to treat the royalties generated by the three devices as capital gain rather than ordinary income. The essence of the plan was the transfer of an undivided one-half interest in the three pending patent applications to three newly organized, independent corporations in exchange for an agreement to pay royalties. The net profits of these corporations—since they were not under common control with Hydra—would not be included in Hydra's income for renegotiation purposes, and the payments made by these corporations to Davis would be taxed at capital gain rates, in contrast to the payments made by Hydra to Davis, which would be taxed at ordinary income rates. In short, the purpose of the plan was to benefit Mr. Davis.

The plan was put into effect. The three new corporations were organized. (Respondent Custom Component Switches is the survivor of those corporations.) The new corporations were owned and controlled by Goodson, Hannam, and petitioner herein, Thomas C. May. May acquired his interest as a bona fide purchaser, without notice, for value. Goodson and Hannam, on the other hand, acquired their interest from Davis by fraud.

An undivided one-half interest in one of the three undivided pending patent applications was assigned to each of the new corporations. Each corporation entered into an agreement for the payment of royalties to Davis. These agreements were not negotiated at arm's length, and the market value of the patent applications was not the decisive factor in their negotiations. Instead, the purpose of the assignment was to carry out the plan to avoid renegotiation and minimize taxes, and this was recognize by May.

However, one factor which the plan did not take into account, and which was unknown to everyone except Davis, was that the pressure switch did not meet federal standards of patentability with respect to novelty, utility, and nonobviousness; that the pressure switch had been on sale in the United States for more than a year prior to the filing of the patent application, and that Davis' sworn statement in the patent application that the switch had not been on sale for more than a year was knowingly false.*

Davis and Hydra furnished substantial start-up help to the new corporations. This included the transfer of production orders from existing customers of Hydra, technical know-how and advice from Davis, space rental, machinery, inventory, transfer of employees, and similar items. The new corporations paid Hydra approximately $100,000 for this assistance. The technical know-how assistance and advice which the new corporations received from Davis were part of the consideration for the payment of royalties.

Patents were issued early in 1958. The plan worked smoothly until 1966. Although demand for the fuel proportioner and the torque spring had dried up in the early 1960's, production of the switch continued at a high level. Davis received substantial royalties each year, and reported these royalties as capital gains. These royalties were not subject to renegotiation.

This litigation commenced in 1966. Davis sought both the interpretation and enforcement of his royalty agreement.

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*The courts below excluded all evidence concerning the validity of the switch patent. Since Custom made an extensive offer of proof on these facts, they must be deemed true for the purpose of this petition.

*The state of the proceedings, and the manner in which the federal questions here sought to be reviewed were first raised.*

The federal questions presented in this petition were first raised in the trial court pleadings, and have been raised at every subsequent stage of the case. The case was tried (commencing January 29, 1970) on the plaintiff's Third Amended Complaint, filed in May, 1969. This Court's decision in *Lear v. Adkins*, 395 U.S. 653, was announced in June, 1969. Custom Component Switches, on whose behalf May* is acting in this petition, raised the federal questions here presented in its answer and cross-complaint to the Third Amended Complaint.

*The action of the courts below with respect to the federal questions.*

**The Trial Court.**

Custom made a written offer of proof in the trial court showing that Davis' switch patent had been obtained by fraud on the patent office, and that the switch did not meet federal standards of patentability. Custom argued that federal law therefore precluded Davis from obtaining either the enforcement or the interpretation of the royalty agreement on the switch patent, and that Custom was entitled to the return of all royalty payments made within the applicable statute of limitations.

*May was permitted to intervene on Custom's behalf after Davis became Custom's majority shareholder, as a result of the trial court's decision that Goodson and Hannam held their stock as constructive trustees for Davis.

The trial court excluded all evidence on the patent questions, stating that the patent was just a tax gimmick, and that any patent, good, bad, or indifferent, would do. The trial court gave Davis a favorable interpretation with respect to the meaning of the royalty agreements and enforced the three agreements as interpreted.

**The Court of Appeal.**

Custom raised the federal questions presented here in its brief and oral argument before the Court of Appeal. That Court refused to consider the defense that a person who has obtained a patent by fraud on the patent office may not, under federal law, receive judicial assistance with respect to the interpretation of or enforcement of a royalty agreement involving that patent, stating simply that Custom's minority shareholders (who owned 39.33% of its stock) "do not have a close enough connection or strong enough interest or show sufficient likelihood of damage to warrant the court expending the judicial time" necessary to determine the federal issue. (Opinion, pp. 58-59.)

Turning to the *Lear* defense, the Court held that Custom lacked "standing" to raise it because Custom had received substantial technical advice and know-how from Davis during the commencement of its operations, and because the patent assignment was part of a plan to avoid renegotiation and to minimize taxes for the benefit of Davis. (Opinion, pp. 85-88.) Secondly, the

Court held that the interpretation* which the trial court had placed on the royalty agreements—that Custom must pay royalties on switches as long as any of three patents were valid—made it futile for Custom to attack the validity of the switch patent. (Opinion, p. 88.) May filed a timely petition for a rehearing, again raising the federal patent issues, which was summarily denied.

**The California Supreme Court.**

May petitioned the California Supreme Court for a hearing on behalf of Custom, raising the federal questions presented herein. His petition was denied without opinion.

*This interpretation is analyzed and affirmed at pp. 68-71 of the Opinion.

## REASONS FOR THE GRANT OF CERTIORARI.

Certiorari should be granted because the decision of the court below is contrary to both the letter and the spirit of recent decisions of this Court with respect to the unenforceability of patents which have been obtained by fraud, and which do not meet federal standards of patentability.

### 1. California Has Reintroduced, Under a New Name, the Doctrine of Licensee Estoppel Which Was Expressly Rejected by This Court in Lear v. Adkins, 395 U.S. 653 (1969).

This Court's decision in *Lear* was based upon the proposition that there is an overriding public interest in the full and free use of ideas in the public domain against which the "equities" of the owner of an invalid patent do not weigh very heavily. After a careful and extended examination of the conflicting interests of the public under federal law and the patent owner under state law, the Court held that neither the parties' contract nor state doctrines of estoppel could prevent a licensee from suing to invalidate a patent. The only question which the Court reserved was whether the equities of the patentee justified the rentention of royalties paid prior to the issuance of a patent, since the licensee would receive special access to the inventor's ideas during that period of time.*

*Lear* does not stand alone. It represents the "consistent" view of this Court ". . . that the holder of a patent should not be insulated from the assertion of defenses and thus allowed to exact royalties for the use

*All royalties involved in the instant case have accrued since the issuance of the patent, so, of course, the question reserved in *Lear* is not here involved.

of an idea that is not in fact patentable. . . ." *Blonder-Tongue Labs. v. University Foundation*, 402 U.S. 313, 349-50 (1971).

See, generally, *Sears, Roebuck v. Stiffel Co.*, 376 U.S. 225 (1964), and *Compco Corp. v. Day-Brite Lighting, Inc.*, 376 U.S. 234 (1964).

In the present case California has created a new doctrine under which state courts may achieve the results condemned in *Lear*. The doctrine is called "standing", but it has nothing to do with traditional concepts of standing. A patent assignee who is compelled to pay royalties on an invalid patent has clearly suffered the type of "injury in fact" which confers standing, as that term is normally defined. See, *e.g., Sierra Club v. Morton*, 405 U.S. 727 (1972); and *California Water & Telephone Co. v. County of Los Angeles*, 253 Cal.App. 2d 16, 23 (1967).

California's approach to standing in this case was nothing more than an evaluation of the private equities of the parties to the transaction. That is a balance which already been drawn in *Lear*.

Moreover, in reconsidering this balance, California has ignored the public interest on which the patent laws are based*

Thus, the court below placed great weight on the fact that the assignment was part of a complex plan to benefit the patent owner by minimizing taxes and avoiding renegotiation. This does not justify a change in the conclusions reached by *Lear*. Under the patent laws, private gain is not the objective. The objective is public benefit, and such gain is simply the stimulus for inventions which benefit the public.

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*The courts below did not even discuss the public interest.

The other factor stressed by the court below was the start-up help furnished by Davis to Custom. However, the states can provide adequate compensation for start-up help without compromising federal patent policy. For example, this Court held in *Lear* that the eight years head start received by Lear as a result of the advice and assistance furnished by Adkins *might* justify the payment of royalties until the patent issued,* but not after the patent issued. Yet California has made no attempt to place a value on the help which Davis gave Custom during the initial stages of its operation. It has simply ruled that Custom must pay royalities for the 17-year life of an invalid patent.**

If an evaluation is to be made, it should not affect the right to challenge the patent. The clear line drawn in *Lear* is desirable on both substantive and procedural grounds. At the most, a patent owner should be entitled to an offset.***

---

*The contents of a patent application are kept secret until the patent issues. In the present case the switch patent was issued only a few months after Davis commenced furnishing technical advice and assistance to Custom.

**The trial court's finding that all of Custom's profits resulted from the business transferred by Davis was overturned by the Court of Appeal with the statement that there was "no telling" how Custom would have fared without such assistance. (Opinion p. 7, n.2.) Of course, Davis did not give up the "profits" earned by Custom, because those "profits" in the hands of Hydra would have been subject to renegotiation.

***California procedure does not prohibit such an offset. The Court of Appeal simply noted that there was no money award for this, and that there was "little support" for the trial court's finding that the $100,000 which Custom paid Hydra for start-up items was "low." Opinion, p. 7, note 2.

**2. The New Rules Developed by California for the Trial of Patent Issues Will Produce a Maze of Conflicting Rules Where National Uniformity Is Required.**

This Court noted in *Lear* that there had been an attempt by the courts over a period of many years to reach an accommodation in patent litigation between the interests of the public under federal law, and the desire of the states to enforce the contractual and equitable duties of the parties. The Court concluded that this effort had been a failure, producing not "creative compromise", but a "chaos of conflicting case law." (395 U.S. 653, 668.)

The adverse effect upon the public interest, and the social and economic costs of needless complexities in patent litigation have recently been noted by this Court. (*Blonder-Tongue Labs. v. University Foundation*, 402 U.S. 313, 334-349 (1971).) *Lear v. Adkins* was a constructive effort on the part of this Court to protect the public interest while at the same time eliminating procedural technicalities in patent litigation. It should be strictly adhered to.

The rule adopted by California is formless, and will produce nothing but confusion. Who can say how much start-up help a patent assignee must receive before it will be deprived of "standing" to attack the validity of the patent. There is no logical basis on which that determination can be made. It is not clear that the value of the start-up help received by Custom was greater than that received by Lear.*

*In *Lear*, this court did not place a value on the help rendered by Adkins, other than to state that the problem faced by Lear was "vexing", and that "Adkins . . . developed a method of construction . . . which improved gyroscope accuracy at low cost", which *Lear* adopted to its "substantial advantage". (395 U.S. 653, 655.)

In any event, the doctrine that a patent owner can somehow insulate himself from attacks on the validity of his patent by making payments to those who desire to use the invention was rejected by this Court in *Scott Paper Co. v. Marcalus Mfg. Co.*, 326 U.S. 249 (1945).

The other basis for the decision of the court below is equally unworkable. A patent owner does not acquire superior equities by using his patent as part of a complex scheme to avoid renegotiation and minimize taxes. These are private goals, of no greater or different importance than the customary objective of producing royalty income. Again, there is no logical basis for saying which private goals are so important as to outweigh the public interest.

Nor can the decision be justified—or logically applied in future cases—if California's principle concern was what it regarded as unfair conduct by the licensee. An examination of *Sears, Roebuck v. Stiffel Co.*, 376 U.S. 225 (1964) and *Compco Corp. v. Day-Brite Lighting, Inc.*, 376 U.S. 234 (1964) should have provided a sufficient answer to any such concern.

Even if the decision is based upon an "unfair" gain to the licencee,* there is no logical basis on which it can be applied to future cases. Economic gain, unauthorized by the parties' contract, is the inevitable result of *Lear*. The prospect of such gain is one of the "practical" factors cited by this Court in support of its decision—those who pay royalties are given an incentive to challenge invalid patents. See 395 U.S. 653 at 670.

The decision of the court below opens up a broad avenue for the evasion of this Court's decision in *Lear*

*The Custom plan did not contemplate the free use by Custom of Davis' switch patent design.

*v. Adkins.* It will encourage forum shopping. Those with the greatest economic incentive to challenge invalid patents will be faced with a wide variety of "procedural" barriers to a trial on the merits.

Moreover, if a three-year-old decision of this Court may be nullified by a simple change in the name of the barrier which is placed in front of a person challenging the validity of a patent, the ability of this Court to serve as a unifying force in the litigation of constitutional and federal questions will be seriously undermined. The smooth operation of our judicial system necessarily requires adherence by the lower courts not only to the letter but to the spirit of this Court's decisions. Policy determinations involving conflicting state and federal interests, once they have been made by this Court, should not be disregarded by the state courts in the absence of a compelling demonstration that the applicable legal principles have changed, or that there was some major factor which the Court did not consider.

### 3. The Rule Adopted in Lear Should Apply With Particular Force in Cases Where the Patent Has Been Obtained by Fraud.

Fraud on the patent office is a serious problem.* The patent office does not have a large enough staff to make an independent examination of each application that is filed. Instead, it must rely heavily upon the rep-

*Davis has emphasized the misconduct of his attorneys, Goodson and Hannam. However, they had nothing to do with his patent application, which was prepared by Harold LeVesconte. Davis' fraud upon the patent office was personal, since he was the person who had placed the pressure switch on sale more than one year prior to the filing of the patent application. Moreover, the minority shareholders of Custom, on whose behalf petitioner is acting, were found to be innocent, and without notice of any wrong doing.

resentations and disclosures made by the applicant. See, *e.g., Beckman Instruments, Inc. v. Chemtronics, Inc.*, 439 F.2d 1369, 1378-79 (5th Cir. 1970), cert. den. 400 U.S. 956. The courts have therefore placed an "uncompromising duty" on patent applicants to deal truthfully with the patent office. *Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co.*, 324 U.S. 806, 818 (1945). Those who violate this duty are denied all relief.

In order to enforce this duty, federal courts do not permit a patent owner who has obtained a patent by fraud to enforce that patent. *Walker Process Equipment v. Food Machinery Chemical Corp.*, 382 U.S. 172 (1965); *Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co.*, 324 U.S. 806 (1945); *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240 (1933); and *Kearney & Trecker Corp. v. Giddings & Lewis, Inc.*, 452 F.2d 579, 594-95 (7th Cir. 1971), cert. den. .... U.S. .... (1972).* It makes no difference that the conduct of the patent owner may be less culpable than that of other parties involved in the transaction.

> "The public policy against the assertion and enforcement of patent claims infected with fraud and perjury is too great to be overridden by such a consideration." *Precision Instrument Mfg. Co, supra*, at p. 819.

This federal policy was totally disregarded by the courts below. Rather than deny all relief to Davis on his switch patent, the California courts tried the issue of

*The fraud on the patent office alleged in *Walker*—a false statement in the application concerning the date the invention was placed on sale—was exactly what Custom offered to prove in the case at bar.

contract interpretation, decided it in Davis' favor, and because of the interpretation which had thus been placed on the royalty agreement, denied Custom the right to try its federal claim* of patent invalidity.

The substance of what the courts below did is two-fold: First, California has lent its assistance to an inventor in the collection of royalties for the production of a device on which he had obtained a patent by fraud. Second, by reaching the interpretation issues before treating the federal defense of unclean hands, the courts below have devised a procedure whereby an assignee can be prevented from raising patent invalidity in defense to a claim for royalties. This procedure tends to insulate the holder of a patent from the assertion of defenses. The deterrence of fraud on the patent office should be by procedures that are designed to produce not minimize sanctions.

All of the policies and goals of the patent and anti-trust laws, as so carefully examined by this Court in *Lear* and *Precision Instrument*, will be frustrated if the decision of the court below is allowed to stand.

---

*In order to reach this extraordinary conclusion, the court first determined that although there had been a separate assignment of the patent on each of the three devices invented by Davis, and that each assignment had been accepted by a different corporation, the assignment transaction must be viewed as single in substance although trifurcated in form." (Opinion, p. 86). Thus, Davis was relieved of the embarrassing position of trying to enforce a contract which related solely to the enforcement of a patent that had been obtained by fraud. Next, the court considered the question of whether or not the contract should be interpreted to provide for the payment of royalties on each of the three inventions as long as the patent for the particular invention was valid, or as long as any of the three patents was valid, and concluded on the basis of a four-page analysis that the latter was the proper interpretation. Since the patents relating to the torque spring and fuel proportioner were valid, the court concluded that the validity of the switch patent was irrelevant.

## Conclusion.

For each of the reasons stated above, Petitioner requests that this Court issue a Writ of Certiorari.

Respectfully submitted,

CHARLES E. BEARDSLEY,
SETH M. HUFSTEDLER,
JEROME H. CRAIG,
*Attorneys for Petitioner.*

BEARDSLEY, HUFSTEDLER & KEMBLE,
*Of Counsel.*

## APPENDIX A.

### Order of Court of Appeal Denying a Rehearing.

"Los Angeles, June 20, 1972

Division Five

37319—*Davis v. Customcraft* [sic] *etc., et al.* The Court: Petitions (4) for rehearing denied."

## APPENDIX B.

### Order of the California Supreme Court Denying Hearing.

"San Francisco, July 19, 1972

. . .

-(2d Civ. 37319, Div. 5)—Allen V.C. Davis v. Goodson et al. (And Consolidated Cases). Petitions of intervenors and appellants for hearing denied."

## APPENDIX C.

### Text of Statutory Provisions.

**35 U.S.C. §102:**

"A person shall be entitled to a patent unless—

(a) the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent, or

(b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States, or

. . .

(e) the invention was described in a patent granted on an application for patent by another filed in the United States before the invention thereof by the application for patent. . . ."

**35 U.S.C. §103:**

"A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negatived by the manner in which the invention was made."

## VOLUME II.

## OPINION OF COURT BELOW.

In the Court of Appeal of the State of California, Second Appellate District, Division Five.

Allen V. C. Davis, Plaintiff and Respondent, vs. Marvin Goodson and William E. Hannam, individually and as co-partners, dba Goodson & Hannam, Defendants and Appellants.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey, Robert Miller, Marvin Goodson and William E. Hannam as Interveners on behalf of defendant Custom Component Switches, Inc., Interveners and Appellants.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Defendant and Appellant.

Allen V. C. Davis, Plaintiff and Respondent, vs. Cal Casey and Robert Miller, Defendants and Appellants.

Allen V. C. Davis, Plaintiff and Appellant, vs. Marvin Goodson and William E. Hannam, Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey, Robert Miller, Marvin Goodson and William E. Hannam and Interveners on behalf of defendant Custom Component Switches, Inc., Defendants, Interveners, and Respondents.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Defendant and Appellant.

Goodson, Hannam, May and Custom Component Switches, Inc., a corporation, Defendants and Respondents. 2d Civ. No. 37319, Sup. Crt. No. 894,709.

Filed May 23, 1972.

APPEALS from a judgment of the Superior Court of Los Angeles County and from orders. Steven S. Weisman, Judge. Judgment affirmed in part and reversed in part with directions. Appeals from order precluding payment of legal expenses dismissed. Order requiring withdrawal of petition for arrangement affirmed.

Hillel Chodos and Kurt Lewin for Allen V. Davis, Plaintiff, Respondent and Appellant.

Beardsley, Hufstedler & Kemble, Charles E. Beardsley, Seth M. Hufstedler and Jerome H. Craig for Thomas C. May as Intervener on behalf of Custom Component Switches, Inc., and as Appellant.

Monteleone & McCrory, and Wilmer E. Windham, for Glen A. Berry, Don Griffith, Cal Casey and Robert Miller, as Interveners on behalf of Custom Component Switches, Inc.

O'Melveny & Myers, Philip F. Westbrook and B. Boyd Hight, for Marvin Goodson and William E. Hannam, as Interveners on behalf of Custom Component Switches, Inc., and for Marvin Goodson and William E. Hannam, Appellants.

Ball, Hunt, Hart, Brown & Baerwitz, and Joseph A. Ball and John R. McDonough, for Marvin Goodson and William E. Hannam, as Appellants.

Since we are not certifying our opinion for publication, we do not set forth initially a recital of the facts or of the procedural steps in the litigation with which aspects of the case the parties and their counsel, of course, are fully familiar.

## NOMENCLATURE

It is expedient to adopt a form of abbreviated nomenclature for individuals, entities, and features involved in the case. Our version follows:

1. *Names:* For brevity's sake we use just last names of the principals, witnesses and attorneys.

2. *Goodson and Hannam:* We use the two names without discrimination as to whether the actor or speaker involved in any given aspect of the case is Goodson or Hannam, since both are bound by the acts or words of the other.

3. *Employee shareholders:* Berry, Griffith, Casey and Miller, as minority shareholders of Custom when referred to separately from May.

4. *Minority shareholders:* May and employee shareholders when referred to as the total group of minority shareholders.

5. *Defendants:* Goodson and Hannam, Custom, and the minority shareholders when a reference to all of them is appropriate.

6. *Interveners:* The minority shareholders and Goodson and Hannam on behalf of Custom, as allowed by the trial court.

7. *Hydra:* The business owned and operated by Davis in any of the various forms which it took at times relevant to the action.

8. *Custom:* The corporations, collectively or separately, formed to take the assignment of an undivided one-half interest in Davis' patents, as said corporations existed from time to time until ultimately being resolved into Custom Component Switches, Inc. Davis has argued that at all times when there was mul-

tiple existence, the three entites should be considered as one under an integrated plan. We consider this a sound approach.

9. *The I.R.S.:* The Internal Revenue Service of the United States.

10. *The R. Bd.:* The Renegotiation Board of the United States.

11. *Attorney and Client:* This terminology includes the concept also of certified public accountant and client when the reference is to Goodson and Hannam and Davis, since Goodson and Hannam bore both relationships to Davis. The professional in each relationship, of course, sustains toward the client a very high duty of integrity and fidelity.

12. *Royalty:* A word of convenience, as employed by counsel, to cover the purchase price for the undivided one-half patent interests assigned by Davis to Custom.

13. *Means for reverter:* (Explained later in the opinion.)

14. *The Custom Plan:* The plan encompassing Custom's formation, its purchase of an undivided one-half interest in Davis' patents, and its operation and its payment of royalties to Davis, all to the end of avoiding renegotiation disadvantageous for Davis and of effectuating his receipt of capital gain income.

15. *60 percent block:* Used to refer to the 60.67 percent of Custom stock which was in the name of Goodson and Hannam and upon which the constructive trust was imposed; the "res" of that trust.

16. *Stock rights:* Used as an abbreviation for the combination of Custom's and the 60 percent block's

rights of purchase of the stock of the employee shareholders, May's right of purchase of the stock of Goodson and Hannam, and May's indemnity-security right in the stock of Goodson and Hannam.

17. *Surcharge:* Term chosen as a word of convenience[1] by the trial participants, which we adopt, to describe generally the type of disgorgement (damages) sought to be drawn from Goodson and Hannam as constructive trustees and as attorneys who had breached their professional and fiduciary duty to their client.

## HYDRA'S PROCEDURAL STATUS

Initially we note that although Hydra was a party plaintiff no judgment was rendered in its favor. This was due to the proposal of Chodos, made after the trial court had determined that the constructive trust would be imposed only on the Custom stock of Goodson and Hannam, that it be imposed only in favor of Davis personally. Hydra should have dismissed its suit or the judgment should have provided that it take nothing. The absence of reference to Hydra can be construed as the latter.

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[1]Obviously not used in its strict equity sense—"To show that a particular item, in favor of the party surcharging, ought to have been included, but was not, in an account which is alleged to be . . . complete." (Black's Law. Dict. (4th ed. 1951) p. 1610.) It could also be called "ancillary" relief. (Compare *SEC v. Manor Nursing Centers,* U.S. Ct. of App. (2d Cir.) January 21, 1972 (September term '71—Dkt. Nos. 71-2011, 2012, and 2026.) (Judgment required the "disgorging" of all proceedings (profits) received in connection with the public offering of Manor stock. A trustee was to receive the funds and distribute to defrauded investors. Said the court: "Clearly the provision requiring the disgorging . . . was a proper exercise of the District Court's equity powers." (P. 1496.)

## APPELLATE GUIDES

We have kept in mind the function of an appellate court to review errors of law, to consider the weight of evidence only in evaluating error, and not to pass on questions of fact; what constitutes substantial evidence; the rules of conflicting evidence and inferences; and the presumption in favor of a judgment, especially as to presuming the trial court's reliance on findings found to be clear and sufficient and disregarding inadequacies of other findings.[2] These principles are ably

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[2]Where a finding is lacking in evidential support but is on a matter which is of so little materiality that a finding either way would not influence the judgment, other findings being sufficient to support the judgment, the error is harmless. (6 Witkin, Calif. Proc., Appeal, § 307, p. 4288.)

Some of the findings are not fully supported or are extravagantly put. The parts that are in this category are not necessary to support the judgment. We allude to most of them in the material following to demonstrate this point of view.

The suggestion in Findings 12 and part of 13 that the Custom Plan was an extension of the Hydra arrangement appears to have been desired by Davis to avoid a contention that the Custom Plan was new legal business, putting the fee aspect within the exception clause of Civil Code section 2235. It was stretching things but it was not necessary. However, it was inferable that the preexisting relationship led to a mutual understanding that Goodson and Hannam were the attorneys Davis would look to in the tax and governmental regulation field.

The wording in Finding 12 that the best course for Davis to pursue was to transfer the largest portion possible of his business to Custom seems to be an extravagant way of covering the start-up help and diversion of orders.

A portion of Finding 13(a) speaks of a representation that it was *necessary* for Davis to establish a "second source" to forestall a bypassing of his patents and to improve his renegotiation position. The word "desirable" and a reference to *possible* bypassing would have made the finding more accurate.

A portion of Findings 13(c) and 27(a) states, in effect, that Goodson and Hannam represented that the Custom Plan had been devised to retain, among other things, maximum ownership interest in the transferred business. This appears to have been an inadvertent inclusion.

(This footnote is continued on next page)

set out in 6 Witkin California Procedure (2d ed.) Appeal, sections 209 and 322, pages 4200 and 4300; sections 248 and 249, pages 4240 and 4241; sections 245 and 254, pages 4236 and 4245-4246; and section 235, pages 4225-4226. We feel that the pronouncements of Division Two (*Davis v. Custom Component*

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Part of Finding 26(a) says that the royalty percentages were represented as the maximum possible under the rules. There is no such specific testimony. A more acceptable inference would be that they were in Goodson and Hannam's opinion the maximum defensible to avoid a government position of common control or ordinary income.

Finding 14(c) is to the effect that Davis could have had a substantial stock interest in Custom without incurring government disfavor. If this were put in the vein of a good possibility and not of a certainty, it would be appropriate.

Findings 14(e) and 31 in part say that Davis could have advanced start-up capital without jeopardizing the Custom Plan and that May being a shareholder was of no benefit. Again these points would have been stated better as good possibilities rather than certainties.

Finding 14(f) is to the effect that there was no substantial reason for the "handshake" period. There was the reason of the short time for diversion of Hydra profits. However, the lack of integrity of this finding is in no way fatal to Davis.

Part of Finding 26(b) is that Goodson and Hannam represented that "in any instance where the provisions of the patent assignment agreements might be different from . . . or silent with respect to, the terms of their original oral understanding, the oral understanding would control . . . ." There appears to be no evidentiary support for this. Also, it might run afoul of the parol evidence rule. (*Masterson v. Sine*, 68 Cal.2d 222, 227; Rest. of Contracts, § 240(1) (b).) Perhaps this rule would not apply where a fiduciary has a duty to point out nonconformities. Anyway the concept of the finding did not really come into play.

Finding 28 makes the point that the payment to Hydra by Custom for start-up items was low. We find little support. There is no money award because of this. Perhaps it was intended as showing a Goodson and Hannam violation of duty. It was not needed.

Finding 33 is to the effect that all of Custom's profits result from the business transferred by Davis and would have been made by Davis. This is all right if intended to mean simply that there is no telling how Custom would have fared if Davis had only assigned the patent interests and provided no start-up help, technical aid or diversion of orders.

*Switches, Inc.*, 13 Cal.App.3d 21) are not conclusive because it did not have the advantage of the full record in this matter when required to rule.

## CONSTRUCTIVE TRUST

There is no question but that Davis' version of the interaction between him and Goodson and Hannam, if it is not subject to being found inherently improbable or incredible or if, for complicity in fraud vis-a-vis the government, it does not put him beyond the assistance of the court, qualified him for the constructive trust remedy which was afforded him. The essence of that version is that Goodson and Hannam took advantage of the renegotiation adversity which beset Davis, of their position as his existing, trusted and highly rated attorneys called in to find a remedy for the threatened harm, of their special and intimate knowledge of the situation, and of the trust and confidence which Davis imposed in them, to get him, by making to him false representations[3] and withholding essential advice, to adopt a remedial plan which they could and did manipulate to foster their own interests at his expense.[4]

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[3]In other words, when Goodson and Hannam were mentally developing the Custom Plan they saw how a takeover of a substantial part of Hydra's market potential could be accomplished and took advantage of their client's need to avoid renegotiation with the end in mind of feathering their own nest.

[4]One series of representations by Goodson and Hannam to Davis was made when the Custom Plan was first proposed; another series, some simply replications, was made when the written assignments were executed. Since we do not feel that any demarcation between the two events is significant to the disposition of the constructive trust issue and since all such representations were made, according to the finding of the trial court, to induce Davis to enter into the Custom Plan and proceed with it, both in its contingent and committed stages, it is convenient to lump them together in our consideration. The first series substantially committed Davis to the Plan. Since, at the time of the execution of the documents, the complications of withdrawing from the

The Civil Code section 2235 presumption, which at one point might have been applicable, is an Evidence Code presumption under sections 601(a) and 605 which imposed upon Goodson and Hannam the burden of proof of the nonexistence of undue influence and insufficiency of consideration. (*Rehmann v. Major*, 5 Cal.App.3d 684, 688.) It did not enter into the ultimate determination of the trial court. Therefore, the presentation of an analysis thereof is not indicated, although we made one. On June 3 the trial court, when giving its reasons for having determined in March that there would be a constructive trust of some kind, stated that it did not believe that the situation was excepted from Civil Code section 2235 under the amendment and further that it had not thought that the presumption had been overcome. It then announced, after the scope of the trust had been argued, that "when I rule I rule sincerely" and that "I sincerely believe that these two defendants [Goodson and Hannam] are liable for fraud";[5] and it provided for nominal punitive damages to make clear its conviction that Goodson and Hannam had practiced actual fraud. Clearly it then was doing more than saying that the evidence negativing undue influence and insufficiency of consideration had not preponderated over that indicating it. The trial court was looking beyond those areas and was finding Goodson and Hannam guilty of actual fraud and deceit, something more than exercising mere undue influence and giving inadequate consideration. As to that greater

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Plan, if Davis had had second thoughts, were not so severe as they would become, the second series of representations can be said to have had some point to Goodson and Hannam, that is, to make sure that Davis strung along with the Plan.

[5]Also, Smith testified, without later contradiction by it that the trial court had told him that it "was convinced that Goodson and Hannam had taken Davis."

wrong, the burden of proof was on Davis, and the trial court decided he had met it.

In the last analysis, when the constructive trust phase of the suit was completed and the trial court had applied its measure of credibility, drawn available inferences, and made allocations of weight, the main factors[6] upon which Davis' case against Goodson and Hannam rested (which we feel the findings adequately cover either by their specific language or by implications inherently within or logically ancillary to them (*Surety Sav. & Loan Ass'n. v. National Automobile & Cas. Ins. Co.*, 8 Cal.App.3d 752, 760; *Kerr Land & Timber Co. v. Emmerson*, 268 Cal.App.2d 628, 635; 4 Witkin, California Proc., Trial, § 339, pp. 3140-3141), and not made unavailable by specific objection (Code Civ. Proc., § 634) are these:

(1) Goodson and Hannam told Davis, in effect, that they would take salaries from Custom; that in light

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[6]We limit ourselves to essentials to avoid entanglement in an endless intricacy of details.

There were other factors indicating that Goodson and Hannam had diverged from their duty of professional loyalty to Davis and had been remiss in giving Davis full and proper advice. By way of example we give brief identification to a few. Goodson and Hannam put themselves in a position of conflicting interests and obligations: to Davis, to Custom, and to May. (Note that Goodson and Hannam were under an $18,000 retainer to May up to 1958 and then $6,000 to 1965.) Goodson and Hannam did not explain this to Davis. Also, they failed to advise that their stock ownership could be a reportable possibility of common control; that once the R. Bd. was satisfied there was a genuine sale of patent interest to an entity not under common control, the royalty percentage was no problem; that renegotiation "phases" of instant secondary source and provision of technical data and know-how gave leeway for some stock interest and security right. Goodson and Hannam did not make all facets of the Custom Plan fully known to the minority shareholders, so as to prevent bona fide purchaser status from insulating them from vendor's lien or constructive trust claims by Davis.

of this they would not charge him an attorney's fee for conceiving of and implementing the Custom Plan and for rendering future legal services; that their ownership of the majority of Custom stock was to enable them to manage Custom so as to best promote the objects of the Custom Plan.

This was repudiated in due course or may even have been put out at the time as a ruse to influence Davis. Goodson and Hannam told the trial court, falsely according to its evaluation, that it had been mutually agreed that their attorneys' fees would be 51 percent of the stock of Custom.[7] It is to be noted that Goodson and Hannam paid $2500 to Custom for their stock and that the witness, Hochman, testified that the taking of an ownership interest in the "res", although done occasionally, was not customary.

(2) Goodson and Hannam told Davis that it was imperative that he not own any stock in Custom, and its stock structure was formed accordingly. This kept Davis from having even a porthole from which he could

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[7]Compare *Estate of Kromrey*, 98 Cal.App.2d 639, where the attorney induced his client to promote his appointment as administrator of certain family estates, used his status to take possession of certain property as if doing so in that capacity, and then, when client shortly died, fraudulently claimed that the property had been given to him personally. Besides indicating that the Civil Code section 2235 presumption could have been used as evidence (which would not be the case now) the reviewing court said:

> "Indeed, it is difficult to understand how counsel for appellant can seriously contend before this court that the record does not support such conclusion of the trial court. The record in the instant case not only justifies but almost compels the conclusion that appellant not only violated the confidential relationship between attorney and client but also violated the ethics of the legal profession. All the perfumes of Araby could not impart a pleasing odor to such a transaction." (P. 646.)

have noted some of Goodson and Hannam's moves to turn the Custom Plan to their own advantage and aggrandizement.

Davis, of course, could have had up to 50 percent of the stock without getting into common control as a matter of law. No doubt ownership of that much would have been unwise, but the tenor of the expert testimony suggests that a small ownership for surveillance purposes would not have been indefensible. In any event, Davis was not made knowledgeable and given the opportunity to make a considered choice. As Davis put it, "[Goodson and Hannam] said that 'This is what you ought to do,'" and they said that "that would be the best thing [he] could do."

(3) Goodson and Hannam told Davis that the stock to be issued to May and any employee shareholder (Humphrey at that time) would be subject to an agreement for repurchase at book value (a type of redemption) by Custom, and they gave Davis the impression that this was to make more feasible their working out a means for reverter.

Goodson and Hannam did not arrange this as to the stock of May or Humphrey. When Humphrey died, Davis was able to persuade the widow to sell the stock back to Custom. The stock which later issued to the employee shareholders was made subject to such an agreement, but Goodson and Hannam, during pendency of the suit, spearheaded the elimination of that right upon termination of employment. May's stock was never made subject to a redemption provision.

(4) Goodson and Hannam represented to Davis, in effect and in general, that as his attorneys they would set up the agreement between him and Custom and

would conduct their independent powers of management in a manner to achieve as much benefit for him as possible.

However, they drafted the patent assignment contract so that: (1) its only reasonable construction was that Custom was at liberty to process products not encompassed in or related to the patents free of royalty obligation, and (2) one construction was that a royalty obligation endured only so long as all patents were extant or that royalty obligation attached to each patent and endured only so long as that patent existed. This would contrast with the obligation to pay the full royalty on the processing of all items, whether the patents to which they related remained extant or not, as long as a claim of any patent or improvement patent existed.

Further they caused Custom to deduct California corporate franchise taxes before computing royalties. They proposed a tapering down of royalties. When Davis retained attorney Keatinge and filed suit, that circumstance did not suddenly sanitize Goodson and Hannam's pre-existent wrongful purpose nor render less reprehensible the flaunting of solemn obligations and high standards deriving from the preexisting relationship of attorney and client.[8] However, Goodson and Hannam caused Custom to forego conservation of its assets, disburse substantial dividends, pay excessive salaries to themselves,[9] pay consulting fees to May for unrendered

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[8]Goodson and Hannam had the attitude that after Davis filed suit they were at liberty to disregard their professional commitments. Goodson and Hannam revealed this outlook when they testified that "the agreement had been in full force . . . at least until the balloon went up in the air in 1966."

[9]Note that the result of the payment of dividends and of excessive salaries was to put Custom assets where questionable fi-

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services, expend large sums in purchasing stock of and making loans to Denes Co., pay very substantial attorneys' fees and litigation expenses to counsel for itself and for themselves and May. In addition, Goodson and Hannam caused Custom to claim that it had been and was processing products not related to the patents upon which it should not have paid and did not have to pay royalties, and to claim that the switch patent was invalid and it therefore had not been and was not required to pay royalty on the processing of items related to that patent.

(5) Goodson and Hannam assured Davis that they would remain his professional advisors and foreseers in tax and renegotiation matters, particularly from the standpoint of the continued efficacy of the Custom Plan.

Their intention was not to do so, but to leave the impression with Davis that they were doing so. They made the claim to the trial court that they told Davis that as the controllers of Custom they could not remain as his advisors and urged him to secure other and independent counsel. The trial court may, and was entitled to have reasoned that they wanted it to appear that the relationship had terminated in order to minimize the liabilities which could stem from its continuation. They maneuvered Rabin into the picture in a manner which would and did give Davis the impression that he was under their tutelage and that they remained Davis'

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nancial responsibility of Goodson and Hannam may well frustrate the benefit that the trial court intended to bestow upon Davis by its judgment.

primary counselors, but which would give them a plausible basis for asserting a termination of the relationship.[10]

(6) Goodson and Hannam assured Davis that, if as his professional advisors and foreseers (as he thought them to be), they should feel that a time had come when the Custom Plan was no longer beneficial to or needed by him, they would find means within the law to put Custom out of business and to cause a return to Davis of the assigned patent interest and a transfer to him of any assets left over after the winding up and the making of a fair provision for those who had been Custom's minority shareholders. (As indicated in our nomenclature paragraph, for the sake of brevity we will use the term "means for reverter" as an abbreviation for this concept.)

It is felt that the proposition that Goodson and Hannam's stock ownership was strictly to enable them to operate Custom advantageously for the Custom Plan and that Goodson and Hannam under proper circumstances would find a means for reverter were deducible by the trial court from the material in the record which is set out in the indicated footnote.[11]

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[10]The procurement of an attorney other than Goodson and Hannam pursuant to their direction could have been considered by the trial court as a demonstration of the fact that Goodson and Hannam had assumed a position which weakened their ability to render full legal service to Davis. Incidentally, this procedure undoubtedly cost Davis some money he otherwise would not have had to pay out, because, if Goodson and Hannam had performed the service, although the process would have reduced Davis' royalties some (by being expensed to Custom), Goodson and Hannam would have been compensated through Custom.

[11]Goodson and Hannam said that they "would hold the stock, and they would own it." ¶ Goodson and Hannam said that they

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Goodson and Hannam had no intention of keeping such surveillance or of carrying out such a means for reverter under any circumstance; rather, they intended to foster Custom's continued existence with reducing allowance to the Custom Plan ensuring maximum value of their stock which they were prepared to claim was

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[illegible] . . . run the stock" of Custom, "being the company not [illegible] by me"; meaning, apparently, that they would run Custom, so as to make the Custom Plan work to the benefit of Davis. ¶ Davis thus [illegible] testified that Goodson and Hannam wanted 51 percent of the Custom stock "so they could operate that company and see that at all times . . . Davis was fairly treated." Even Goodson and Hannam testified that Davis wanted control of Custom in the hands of men whom he knew, and that "[we] presumed he trusted us." ¶ Davis testified: "I presumed . . . that this [apparently referring to the stock owned by Goodson and Hannam and residual Custom assets] would revert to me at such time as [Goodson and Hannam] saw fit, when it looked [to them] . . . acceptable [legally] and desirable to make a change in the [Custom Plan]." The trial court could have inferred that Davis' presumption arose from an explanation given to him by Goodson and Hannam. There was no objection that Davis' testimony amounted to a conclusion. ¶ With respect to the Custom stock, Goodson and Hannam said, "in effect" that they "would . . . own it and return it at such time as [they] saw fit." ¶ Davis affirmed that Goodson and Hannam made him believe that he could not have an indirect stock interest in Custom. ¶ Davis testified that he could not recall that Goodson and Hannam in their statements to him had used the phrase that they would hold the Custom stock in trust. The trial court, of course, could determine from that testimony that Goodson and Hannam had not used any such phrase. ¶ Goodson and Hannam stated that "they would hold the [Custom] stock [and] operate the company." ¶ Davis testified that he presumed from what Goodson and Hannam said that "this" would revert to him automatically when Goodson and Hannam considered it desirable and acceptable. ¶ What Davis considered was to revert he explained as "everything". It seems quite clear that Davis meant by this term the undivided one-half patent interest and the residual Custom assets. Davis explained that the means of effecting the reverter would be the default process he had mentioned, deliberately initiated; but he moved from the specific to the general by adding that he did not know how the reverter was going to be accomplished and that Goodson and Hannam "were going to work it out." As to the time when the reverter might occur, Davis gave an indication by making reference to "on going patents which would make this program run into the future, so it would be maybe

their attorneys' fee; and, eventually to capitalize on the residual value thereof.

Unfortunately, it appears, in light of supportable trial court views, that Goodson and Hannam permitted the lure for personal aggrandizement to obscure what should have been their unflagging perception of and

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some time before we would ever get to that [reverter process]." Otherwise, Davis understood that any time that it was desirable, Goodson and Hannam would make (the business) revert. ¶ Davis further testified that he would not split his company (meaning, it is felt, the marketing potential of his devices) if he had not expected that it would recircle in the long run. Davis put it that in his estimation whether this expectation (which the trial court could have considered as stemming from loosely made unilateral representations by Goodson and Hannam) made the stock in Custom (and thus, indirectly, Custom itself) his property was a legal determination. ¶ Davis testified that he knew that he did not own any of the stock of Custom. ¶ Goodson and Hannam told Davis that they were going to hold the stock and that the stock issued to Humphrey would have a repurchase clause, a feature which Davis interpreted as an aid to ultimate reverter. ¶ Davis testified that he was not worried that others than Goodson and Hannam had stock in Custom. He pointed out that Goodson and Hannam had stated that there would be a stock repurchase agreement with May as well as with Humphrey. Davis felt that even if May held stock, Goodson and Hannam were in control. It was Davis' understanding that if the Custom Plan were scrubbed, May would be paid on some acceptable basis. ¶ Referring to the interest which the shareholders of Custom had, Davis observed that he guessed it was an ownership. ¶ Davis testified that he understood that the Custom Plan was a plan for him and if there was anything he did not like about it, Goodson and Hannam "would work it out." This concept, it will be noted, is not so drastic as to say that if Davis announced at any time simply that he did not like the operation of the plan, it would be scrubbed and everything would come back to him. Thus, the point is still viable that Davis placed great reliance on the professional loyalty, ingenuity and foresight of Goodson and Hannam. ¶ Davis testified that he knew that he had to sell a one-half interest in his patents, but he understood that Goodson and Hannam were going to return it when they felt the plan had served its purpose. ¶ Goodson and Hannam claimed that they discussed possibility of reverter with the R. Bd. It is doubtful that the trial court believed this; but the fact that Goodson and Hannam brought this up suggests their concession that they had made representations to Davis about it.

attention to the interests of Davis and to cloud their appreciation of the extent of the fiduciary and professional loyalty and obligation owed by an attorney to his client.[12] It was the duty of Goodson and Hannam, as the acting attorneys for Davis, to obtain for Davis every advantage they could and to avoid at any point placing their own interests ahead of his. (*Meinhard v. Salmon* (N.Y. 1928) 164 N.E. 545; *Eschwig v. State Bar*, 1 Cal.3d 8, 16; *Clancy v. State Bar*, 71 Cal.2d 140, 146-147; *Radner v. Trasher*, 57 Cal.2d 244, 249-250.)

Clearly this conduct constituted a violation of the Goodson and Hannam trust position (*Trafton v. Youngblood*, 69 Cal.2d 17, 27; *Rebmann v. Major, supra*, 5 Cal.App.3d 684, 688; *Gold v. Greenwald*, 247 Cal. App.2d 296, 306-309), and of the high duty standards attendant to the relationship of attorney and client and amounted to fraud[13] providing the trial

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[12]We cannot say that the trial court was not justified in taking the position, which it manifestly did, that when Goodson and Hannam told Davis that the best thing that he could do was to get all he could into Custom (so that 65 percent of Custom's net profits would come back to him in capital gains), they had more in mind the idea that this build-up of the business for Custom would make the pot so much bigger for themselves than the thought that it would benefit Davis. The same is to be said as to Goodson and Hannam's advice to Davis that it was necessary that he furnish tools, know-how, and personnel to Custom and to get customers to release existing contracts with and commitments to Hydra and place them with Custom; that is, their motive was as much to increase the stake for themselves as it was to insure the successful operation of the Custom Plan.

[13]Because of the actual fraud finding, undue influence and lack of consideration became a secondary feature. However, the trial court had ample basis for taking the position that at the time the renegotiation problem of Davis came up, Goodson and Hannam were his attorneys, having recently worked out the fragmentation of Hydra and counselled him concerning personal estate matters and being considered by Davis as his attorneys for dealings with the government. At least the influence of Goodson

court with the authority, in fact imposing upon it the obligation to declare a constructive trust on their 60 ⅔rds percent of Custom stock. (*Redke v. Silvertrust*, 6 Cal.3d 94, 106; *Day v. Greene*, 59 Cal.2d 404, 411; *Ehret v. Ichioka*, 247 Cal.App.2d 637, 642-643.)

The purpose of the constructive trust would be among other things: (1) to remove Goodson and Hannam from their undeserved position of control in connection with the Custom Plan, (2) to take from them anything of value[14] gained through their perfidy (prevent unjust enrichment of the defalcating constructive trustee, which is the paramount concern of the courts, not damage to the constructive beneficiary) (*Amen v. Black* (10 Cir. 1956) 234 F.2d 12, 21), and (3) to put Davis in a position to make derivative claims for the misapplied corporate funds and to cause

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and Hannam acquired by the recent attorney and client relationship remained. (See section 2235, Civ. Code.) Goodson and Hannam, through their position as the attorneys to whom Davis looked to and trusted, had the ability to influence him. The trial court was entitled to decide that Goodson and Hannam proceeded to exert this influence too strongly to obtain an advantage from Davis contrary to the command of section 2231. Section 2234 of the Civil Code states that this violation was a fraud against Davis. Because of this, the imposition of a constructive trust to ameliorate that fraud was a proper equitable device for the trial court to employ.

Goodson and Hannam, of course, gave no consideration to Davis for taking more out of the Custom Plan than was planned. Also, the trial court could consider that Goodson and Hannam had put Davis into a plan which the latter thought could be modified or scrubbed legally when it was no longer advantageous to Davis, but which Goodson and Hannam well knew could not be done without great difficulty and hazard and did not intend to aid in accomplishing in any event. Thus, there was insufficient consideration for Davis because he did not get what he bargained for.

[14]Only the stock was reachable; the dividends apparently had been dissipated, otherwise the traceable residuals would have been an object of the constructive trust rather than of a damage award.

Custom either to dissolve subject to such opposition as the minority shareholders might interpose or to deal with himself as to the continued operation of the Custom Plan, its interpretation, reformation, modification or termination, subject to any counter derivative moves that the minority might be able to achieve.

The primary and fundamental attack of Goodson and Hannam against the breach of fiduciary duty and constructive trust aspect of the judgment is that Davis' trial court story most favorable to himself is unbelievable and can and should be rejected as such by this court even though the trial court believed it. The Davis version is unbelievable, they say, because it is inherently improbable that Goodson and Hannam would have spoken, acted and (inferentially) thought as Davis related and because Davis was caught in inconsistencies in his in-court and deposition testimony in the instant case and in a contradiction to both in a statement read into his Cook deposition. The factors of inherent improbability and of impeachment were for the trial court. (6 Witkin, Calif. Proc., Appeal, § 251, p. 4242; *Bechtold v. Bishop & Co., Inc.*, 16 Cal.2d 285, 291; *People v. Wilburn*, 195 Cal.App.2d 702, 706; *Estate of Pelton*, 140 Cal.App.2d 512, 515-516.) The appellate court cannot make its own evaluation of credibility, even though to some the evidence would have seemed so unbelievable as to compel a contrary judgment. (Witkin, *ibid.*) Seemingly, a rare variance from this fundamental rule is recognized. *Evje v. City Title Ins. Co.*, 120 Cal.App.2d 488, 492, cited by Witkin, suggests that this is when the testimony rejected by the reviewing court is "wholly unacceptable to reasonable minds" or "unbelievable *per se*." (Apparently these descriptive phrases mean something more than in-

herently improbable.) We do not feel that the Davis testimony is in the *Evje* category.

We consider a few significant examples. Goodson and Hannam argue that it is unbelievable as a matter of law that they assured Davis that they would continue as his professional advisors and foreseers; that they would, when the circumstances permitted, find a means for reverter;[15] that they would be satisfied with reasonable salaries from Custom as their remuneration and would not charge any attorneys' fees for working out the Custom Plan and rendering succeeding services, because if the former had been part of the arrangement, it would have been vulnerable to government attack and if the latter had been carried out, it would have constituted economic suicide on their part. However, these examples assume forthrightness on the part of Goodson and Hannam, an attribute the trial court found in want. Moreover, the testimony of the experts, as discussed more fully later, did not establish that the mentioned factors would doom the Custom Plan, and Davis brought out that Goodson and Hannam had not been long at the practice of law and were of modest worth, were "young and hungry" as the trial court put it.

Neither the "lock, stock and barrel" testimony in the instant deposition (which is the strongest example

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[15]It seems to be the argument of Goodson and Hannam that the story that they represented that they could achieve a means for reverter within the technicality of the law cannot be believed because it is out of reason that Davis would have attributed that much ingenuity to Goodson and Hannam. However, such a belief by Davis is not at all improbable considering his observance of and feeling about the Hydra fragmentation. Certainly his conception would not have been shaken, but rather fortified, had he been able to foresee the maneuvers pursued to retain the Convair order as a Custom project.

and the one continually stressed by Goodson and Hannam) nor the assertion of *no interest* found in the Cook statement are necessarily incompatible with Davis' trial court position. The former was given after suit had been filed and when Davis no doubt was aware of the doctrine of constructive trust in rectification of breach of fiduciary duty, and it can be rationalized as a layman's way of putting that concept.[14] It is true that Davis answered in the affirmative to the query if that was how he felt in 1957, but he added the qualification "in the way I've just explained it to you." The trial court could have considered that what Davis meant by these qualifying words was that if he had known in 1957 about Goodson and Hannam what he does now, he would have felt the same constructive trust type of proprietorship and would have been acting on it. At the time of the Cook deposition, a different angle was under exploration and Davis was under the tutelage of Goodson and Hannam. They, themselves, testified that the strategy was to emphasize business reasons (for the patent assignment) and only to go into the tax and then the renegotiation features if the questioning called for it.

In any event, the trial court was not required to hold Davis to occasional unfavorable fragments of his testimony or to disbelieve his trial version, even though it felt that he had not told the absolute truth in the Cook deposition. (*Estate of Pelton, supra*, 140 Cal.App.2d 512, 515-516: "The trial court . . . was not obligated to disbelieve the testimony given by the witnesses at the trial, because of their admissions of perjury in their depositions. It was the exclusive province

[14]Or a verbalization of an instinctive reaction as to what perfidy on the part of his trusted attorneys would bring about.

of the trial court to winnow the grains of truth from the chaff of falsehood in the testimony of these witnesses, and its determination of what was true and what was false cannot be reviewed by this court." See also, *Holman v. Viko*, 161 Cal.App.2d 87, 99.)

## IN PARI DELICTO DEFENSE

Since we have concluded that the trial court's belief in the testimony of Davis and disbelief in that of Goodson and Hannam is to be sustained, we consider Goodson and Hannam's alternate defense. They argue Davis' disentitlement to the aid of the court due to illegality with optimistic conviction. This agreement postulates that there was indeed a dummy shareholder set-up which made the claim of separate control a fraud on the government for which Davis should be held accountable either because of conspiratorial concealment or of basic illegality.

We have already determined that the trial court was not required to and did not adopt that interpretation of Davis' testimony. It remains, nonetheless, to determine if the illegality contention applies to Davis' means-for-reverter version.

Such a concept was not included in the hypotheticals submitted to the R. Bd. and the I.R.S. to obtain rulings. But there was no representation to the agencies that the program ultimately adopted would conform; and there was no requirement that the parties follow the hypothetical plan, or, specifically advise the agencies if they made any variations. As Goodson and Hannam put it, the obtaining of rulings was to set principles. This also was the feeling of the experts, Page and Kragen. The tenor of the expert testimony indicates that the governmental agencies did not particularly

expect that there would be conformance to the hypotheticals and were aware that the contractor could be setting up a varying plan which he felt was still properly within the principles but which the government might not. It is a matter of judgment on the part of the contractor whether any changes individually or in combination have caused his program to approach a common control situation.

Nothing in the record on the point of how close the means-for-reverter concept, in the setting of the other features of the Custom Plan, put the plan into a common control situation is of a positive nature.[11] The testimony of Kragen, Page and Pavitt was essentially noncommittal and in some respects favorable to Davis. As the testimony of Page suggests, it is the type of thing where the client is entitled to trust his attorney's evaluation.

Page testified in effect that one got into an imponderable when considering an arrangement for a reverter. He spoke of the desirability of making a flexible plan so that the client would not suffer a forfeiture in the event of a change in circumstances. He indicated that one could set how long whatever plan was put into effect would be operable, stressing that the renegotiation inquiry was a year-to-year thing. He pointed out that the renegotiation law was subject to change at any time, and that one would have no control over whether a plan would be in conformity say five years hence. He left the inference that there was nothing

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[11]We note that during about two years when May owned all of Proportioners, Goodson and Hannam supervised returns to the R. Bd. which in effect represented that Proportioners was not under common control with Switches, even though it owed May $32,000 and was still the beneficiary of some of his guarantees.

amiss in anticipating this with at least the concept of meeting such change with modifications or even with the scrubbing of a plan if that were so indicated. When asked, in effect, whether it would be appropriate to have a provision for reverter if a change in law made a plan no longer effective, he said no more than that this would present a question, and indicated (obviously to avoid the possible involvement government examination of the agreement might bring) that he would just advise the client that if the law changed he would then make whatever arrangements he could to aid the client. He put it that the less there was in the agreement, the more flexibility there would be for meeting contingencies, saying that if one can trust the person with whom he is dealing, he is better off not being too specific about protections. This was close to the Davis version of Goodson and Hannam's proposal—in effect, the assurance that if the situation warranted and allowed it, through their resourcefulness and ingenuity, they would find a way to scrub the plan, return the patent interest and transfer residual assets. The trial court was warranted in concluding that Page did not consider such an approach unforthright. Page referred to *Southland Steel v. War Contracts Price Adj. Bd.* 13 T.C. 652, a family relation tie-up, wherein a finding of common control by the R. Bd. was reversed by the tax court. This decision would indicate that some features seemingly indicative of common control might be found not to be such and would lend justification in many instances to a contractor acting on the premise that his plan is defensible. Finally Page recognized the use of the vendor's lien to assist in the process of an engineered reverter, and he recommended low cost licensing to a third party in the case of a recalcitrant Custom.

The tenor of Kragen's testimony is that from the income-tax angle Goodson and Hannam's means-for-reverter assurance would not have made showing royalties as capital gains on a tax return an illegal act. In particular, he testified that under Internal Revenue Code, section 1235 (26 U.S.C.A. § 1235) Davis could have held stock in Custom and had a security interest in and right of recapture of the assigned patent interests. Neither, according to him, would it have been a fraud to fail to disclose in tax returns the royalty duration intent. Apparently this would be on the basis that there would be a fair difference of opinion whether the Custom concept in the future would cause some portion of the royalty payments to be classified as ordinary income. Kragen also testified that the government looked at the situation year by year and not overall.[18]

It is true that Pavitt testified that one could not create, "a sham transaction where you put it out and then pull it back"; but this seems to relate to a secret express trust either as to the patents or as to Goodson and Hannam's Custom stock. On the subject of a means for reverter, Pavitt's observation was that "these agreements not to continue in business or to get out are always very dangerous in writing", suggesting that the unilateral oral assurance of finding a means for reverter at the appropriate time does not lack propriety.

To us, this particular issue boils down to whether there was a failure to follow governmental requirements in connection with the filing of R. Bd. forms, and, if so, whether the deceit involved, so far as Davis is con-

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[18]Incidentally Kragen testified that the furnishing of technical data by Davis to Custom would have had no effect income-tax-wise.

cerned, was so aggravated that the court will not weigh culpability as between him and Goodson and Hannam, but leave them as it finds them.[19]

The forms, RB 90 (statement of nonapplicability) and RB 1 (standard report) leave it up to the contractor to say whether he is under common control with another. If he says "yes," he is to supply a brief explanation. The instructions for RB 1 caution that whenever any possibility of common control exists, the facts should be disclosed; but the form is not set up that way, and the tenor of the testimony of Page suggests that the practice was to follow the form and give details only when the contractor felt that he was under common control.

It was, of course, the duty of Goodson and Hannam to formulate such a plan that it would not bring about a violation of requirements to submit a form which did not contain a recital of common control or an explanation of circumstances indicative thereof; and Davis had the right to rely on their doing so. It was not said by Goodson and Hannam that they hinted to him that they had done otherwise. He testified that he thought the plan was legal and that he had no idea that any fraud was involved. When asked if Goodson and Hannam had told him that the R. Bd. had taken the position that there could be no right of recapture, he responded that he did not recall that at all. Davis further testified:

> "[I]f I were to make a conclusion, it was that [Custom] couldn't be a sham company, yes. [¶]

[19]The situation was not as if the R. Bd. and I.R.S. had challenged the Custom Plan because of knowledge of the means-for-reverter assurance and Davis resisted, and a court decision had to be made one way or the other on legality.

I had to follow the law, whatever the law was, and that is what we did, . . . ."

"[I]t [the Custom Plan] was [Goodson and Hannam's] proposal [,] and I accepted it."

Davis also testified that it never occurred to him that there would be a fraud problem, and that "[w]e followed the rules, whatever they were."

Initially the preparation of the R. Bd. forms was under the supervision of Goodson and Hannam and their execution by Davis was under their influence and tutelage. There were several variances in the ultimate Custom Plan, aside from the means for reverter, which might or might not have been classifiable by a conscientious contractor as pointing toward common control. Goodson and Hannam have not urged that there was any fraud in not revealing these. If there was any impropriety in the form filling, Goodson and Hannam were the contrivers thereof. Considering how Goodson and Hannam emphasized to Davis that they owned the stock, that he had no control over Custom, and that they would seek means for reverter only if circumstances called for and allowed it, there was no reason for Davis to suspect that the forms were deceptive to the government.

Nonetheless in our opinion the government, under its instructions, was entitled to an explanation of the Custom Plan on the thesis that Goodson and Hannam's stock ownership, the duration of the royalty obligation, the royalty percentages, and the collateral assurance of means for reverter, taken together, did pose a possibility of common control.

If there had been a disclosure, it would remain an open question whether the R. Bd. would take the

stand that there was common control or even would request a showing of justification against the possibility. As we see it, there is no cause for us to enter this alien field to make a determination ourselves. It is enough for us to appreciate that it is no dead certainty that the R. Bd. and the tax court would consider that there was common control; that Davis had an arguable position. The gravamen of the fault is not meeting the requirement of making known the potential. Under those circumstances matters would not have worsened by the fact that there would follow an adverse adjudication. We do not sanction the nondisclosure, but we do explicate the subordinate involvement of Davis. It was not such as to require a solicited court to refrain from intervening to aid Davis as the victim of Goodson and Hannam's wilful breach of professional duty as found by the trial court. The situation is close to that found in *Clark v. Millsap*, 197 Cal. 765. (See also *Sontag v. Denio*, 23 Cal.App.2d 319 and *Young v. The Young Holdings Corp., Ltd.*, 27 Cal.App.2d 129, 151.) It should be governed by its principles. *Perma Mufflers v. Int'l Parts Corp.*, 392 U.S. 134, 140-141 (reviewed in Schiebelhut, *Demise Of In Pari Delicto*, (1972) 60 Cal.L.Rev. 572) discloses the disposition of the United States Supreme Court to subordinate the defense of In Pari Delicto to doctrines of more significant value which, in our instance, would be that of the high professional fiduciary duty which an attorney owes to his client.[20] (Compare *Smith v. Turner*, 238 Cal.App.2d 141, 148-153; *Tri-Q Inc. v. Sta-Hi Corp.*, 63 Cal.2d

[20]Compare the threat of private action supplementary to the example of State Bar proceedings as a vehicle to encourage adherence to lofty professional standards with the threat of private action, in the trade-restraint and corporate securities situations, as a vehicle to foster public benefit through competition and equality of disclosure.

199, 218-219 and *Norwood v. Judd*, 93 Cal.App.2d 276, 288-289.)

Both sides have claimed comfort from *Redke v. Silvertrust*, 6 Cal.3d 94. We believe that its rationale aids Davis.

The main point of Redke for us is the Supreme Court's position, under circumstances somewhat similar to ours,[21] that the naive beneficiary will not be barred from recovery from the designing fiduciary on the ground of a public policy to deter others who are, in fact, mutually culpable. For providing additional elucidation on this point and for showing further instructive aspects of the case, we give our detailed analysis and comparisons in the indicated footnote.[22]

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[21]A deception exercised against the government when the wrongful act is contrived by one (in *Redke* through whom resistor claims) owing a fiduciary duty to another (in *Redke* through whom claimant seeks to take) with the fiduciary being sophisticated and the beneficiary unsophisticated in the involved field whereby the beneficiary gains value and the fiduciary usurps part.

[22]In *Redke*, Mitzi sought to have the court determine that her stepfather, Sam (and so, on his death, his estate), became constructive trustee for her (Mitzi) of the property willed to him by his wife, Ann (Mitzi's mother), because Sam's repudiation of his promise to Ann to exercise in favor of her daughter, Mitzi, the unlimited power of appointment given to him under Ann's will constituted a violation of the conjugal fiduciary and confidential relationship between husband and wife, a species of constructive fraud, which justified the imposition of a constructive trust. (Pp. 100-101.)

Sam's estate urged that this should not be done because, on notice to Ann, Sam's promise to appoint to Mitzi made their plan to get the marital deduction (which Sam did get) by an apparent unlimited power a fraud against the government.

By way of comparison, Goodson and Hannam are saying that the court should not make Davis constructive beneficiary of the Custom stock because, on notice to Davis, the failure to give an explanation of indicators of common control in the R. Bd. forms was a fraud against the government.

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The holding that Davis is not barred from recovery against Goodson and Hannam is subject, of course,

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What the Supreme Court is saying in *Redke* is that there was evidence accepted by the trial court that Ann had no appreciation, by which Mitzi would be bound, of the illegal aspect of the understanding between her and Sam, and, further, that it is not to be ruled that, despite this innocence of Ann, Mitzi will be barred from relief on the ground of a public policy to deter other husbands and wives from working out such an arrangement, by making it plain that if one finds that the other has been untrustworthy, he cannot gain court assistance against the other by falsely claiming innocence of the fraudulent aspect against the government.

Again by way of comparison, in our case, Davis was seeking to have the trial court determine that his attorneys, Goodson and Hannam, became constructive trustees for him of the Custom stock which they got by reason of his acceptance of their Custom plan under circumstances wherein Goodson and Hannam were guilty of fraud which constituted a violation of the professional fiduciary and confidential relationship between attorney and client.

Goodson and Hannam are urging that this should not be done because the means for reverter concept made the filing of the R. Bd. forms a fraud on the government.

In effect, the trial court in the instant case has said that there is evidence that Davis had no appreciation that there was any such fraudulent aspect and further that the law should not be that, despite Davis' innocence, he will be barred from relief on the ground of a public policy to deter other lawyer-client combinations (wherein both have fraudulent scienter) from acting similarly, by making it clear that if the client finds that the lawyer turns out to be unfaithful, he cannot gain court assistance against him by claiming false innocence of a fraudulent aspect against the government.

One instructive part of *Redke* is the principle that the violation of a confidential and fiduciary relationship insures the remedy of imposition of a constructive trust. (Pp. 100-101.) In *Redke,* the violation was considered a constructive fraud.

In the instant case, by the award of nominal punitive damages, the trial court made it known that it was finding actual fraud. Of course, in *Redke,* a statute of frauds problem was raised which has no parallel here.

In *Redke,* it was pointed out, in effect, that Sam could have avoided the effect of any aspect of illegality in the agreement by not claiming the marital deduction or by disclosing the agreement to tax authorities which, no doubt, would have resulted in the disallowance of the marital deduction.

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to his answering to the government on whatever position it should take. From its standpoint, the government

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In the instant matter, the "understanding" was open to the interpretation by the trial court that there would be ways whereby the major part of the Custom enterprise could be recircled to Davis which would be within the law. Also, it would seem that no illegality problem would arise, if, in connection with such a recircling, the circumstances were made known to the government and Davis was willing to accept whatever retroactive detriments might be imposed by it.

It was also stressed in *Redke* that Ann was a housewife with little familiarity with business transactions, that Sam was the dominant influence in managing the conjugal affairs, that Ann had no reason to suspect that Sam would proceed illegally, and that "'[n]otwithstanding any explanations that may have been offered to her, it is doubtful that Ann had any particular or clear comprehension . . . at any time of the technical aspects of a marital deduction, or an unlimited power of appointment, or [of] the tax laws pertaining thereto." (P. 103.)

In the instant case it was open to the trial court to consider that Davis was a lay person without sophistication in the indicated field of taxes and government regulation; that Goodson and Hannam were knowledgeable in that area and were the dominant influence in arranging the tax and anti-renegotiation plans; that Davis was under their tutelage when the first renegotiation reports were sent in; and that Davis had no reason to suspect that Goodson and Hannam would proceed illegally. As noted above, Davis testified:

"If I were to make a conclusion, it was that [Custom] couldn't be a sham company, . . . ¶ I had to follow the law, whatever the law was, and that is what we did."

* * * *

"[I]t [the Custom Plan] was their proposal [,] and I accepted it." Davis testified that it never occurred to him that there would be a fraud problem.

The trial court also could have found that Davis had no idea what was or was not an "indirect interest" in Custom and that he, because of the lack of detailed explanation to him by Goodson and Hannam and of his practice of accepting carte blanche programs recommended by the lawyers he had chosen ("[I]t was a tax plan . . . and I left it up to them." "I didn't, however, expect to approve of anything in particular." "I didn't check the contract to see . . . how it squared with [what Goodson and Hannam were] telling me . . . ." "I don't second-guess important matters, I use counsel."), Davis had no clear comprehension of the technical aspects of the rules about common

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is better off with assets in the hands of the contractor it might consider the true receiver of the profits which

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control and capital gains and of how the Custom Plan met them and what the loose understanding dehors the contract about reverter under appropriate circumstances would affect the defensibility of the plan.

The Supreme Court in *Redke* (at p. 103) pointed out that although a guilty state of mind on the part of Ann could have been inferred, it was not, and observed: "As noted in *Platt v. Wells Fargo Bank*, . . ., 222 Cal.App.2d 658, 664, questions of 'intent' and 'purpose' are ordinarily questions of fact to be determined by the trial court." It then alluded to the trial court's findings as to Ann's state of mind, including the fact that it was Sam who counselled her, that Ann had little knowledge of business transactions or tax laws, and that Ann entrusted Sam with the responsibility of managing her affairs.

In the instant matter implicit in the trial court's findings and supported by the overall tenor of the evidence, is the fact that it was Goodson and Hannam who counselled the Custom Plan, made the representations about recycling, and supervised the compilation and execution of the annual reports to the R. Bd.

It is significant that in *Redke*, if the plan of Ann and Sam was that the latter would take the marital deduction and then would commit himself to willing all Ann's property to Mitzi under his unlimited power of appointment, the agreement undoubtedly was illegal.

In the instant matter, the loose understanding for an ultimate reverter under appropriate and allowable circumstances at the most would have required an explanation of that understanding in the forms to be filed. There would only have been illegality if Goodson and Hannam and Davis had schemed not to reveal the understanding even if they felt that the regulations were interpretable as requiring it. Actually, in one sense, there was no agreement as such, rather, there was a unilateral indication by Goodson and Hannam, which Davis thought was reliable, that they, in the spirit of their professional devotion to his interests, at some appropriate time in the future, would devise a process to get back to Davis a substantial portion of any accumulated assets of Custom and the marketing potential of his devices. By imposing a constructive trust, the trial court was not enforcing a bargain between Davis and Goodson and Hannam (and certainly not between Davis and Custom) but, rather it was, as a means for rectifying constructive fraud, dislodging Goodson and Hannam from the advantage they had gained in failing to ad-

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it feels are renegotiable and ordinary income in character.

Since this opinion is not being published and the governmental agencies will not have that means of knowledge of its contents, the trial court, in the exercise of its equitable powers may wish to see that copies of this opinion are made available to the I.R.S., the R. Bd., and the Franchise Tax Board.

## STATUTE OF LIMITATIONS

The essence of the contention of Goodson and Hannam under this heading is that awareness by Davis of the contents of Goodson and Hannam's June 1961 memorandum (Exhibit R) and of discussions between Goodson and Hannam and Rabin on its subject matter should have put him on inquiry.[28] (Civ. Code,

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here to the high standards of their profession and to the strong duty of loyalty to the interests of their client.

With respect to the matter of policy, we note the following language in the *Redke* opinion (at p. 104):

> "Defendants also urge that regardless of Sam or Ann's intent, all such oral agreements should be declared void as against public policy, in order to deter others from attempting to evade death taxes from such a device. We cannot so readily assume, however, that other persons will be induced to violate the tax laws in this manner, or that the taxing authorities will fail to discover their fraud. [Footnote omitted.]"

The omitted footnote points out that there is no limitations period on actions by federal taxing authorities involving fraudulent attempts to evade taxes.

Thinking in terms of the instant case, it may well be that the same rule would apply to renegotiation matters.

[28]At trial it also was urged that Davis should have been alerted to duplicity on the part of Goodson and Hannam by awareness of Custom's indulgence in research (indicating movement away from Custom Plan) and exposure to the Proportioner manipulation (indicating position of absolute proprietary interest). However, until after suit was filed defendants made no pretext that Custom was processing any new type of product upon which it

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§ 19.) The memorandum contained material of neutral, beneficial and detrimental cast—a proposal for royalties on profits of subsidiaries; a recommendation for study of uncovered licensing problems; a suggestion that any revised agreement be reviewed by patent counsel; and a proposal for reduced royalty percentages above certain gross totals. In November 1965 something along the line of the last proposal, perhaps more emphatically put and uncoupled with compensating benefits, apparently did lead Davis to inquiry through Keatinge.[24] Where a fiduciary relation or its enduring influence pertains[25] (as the trial court found here) obviously there is less cause for suspicion and no duty to reexamine the circumstances (*Hobart v. Hobart Estate Co.*, 26 Cal.2d 412, 440). The law does not require one to suspect his fiduciary. The statute of limitations is not intended to impose on a defrauded party the burden of discovering a fraud perpetrated by one standing in a position of trust and confidence. (*Amen v. Black*, 234 F.2d 12, 21, 26.) (See also *Black v. Riley*, 20 Cal.App. 199, 202 [it is only when attorney assumes hostile attitude that client cannot assume attorney's fidelity and dedication to client's interests]; *Rutherford v. Rideout Bank*, 11 Cal.2d 479, 486 [where fiduciary relation pertains, facts which ordinarily require investigation may not excite suspicion];

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did not have to pay royalty; and the Hydra fragmentation had accustomed Davis to maneuvers of the Proportioner type and anyway it was accomplished to meet a renegotiation problem.

[24]It is apparent that something transpired at this meeting which was illuminating to both Davis and Goodson and Hannam, because Goodson and Hannam testified that they tied the Keatinge call back to the November meeting.

[25]Not to be overlooked is that Goodson and Hannam indicated that "their [operations through] ownership of Custom would constitute rendering [continuing] legal service to Davis in connection with the [Custom] [P]lan."

*Barron Estate Co. v. Woodruff Co.*, 163 Cal. 561, 576 [victim may justly rely on good faith of guilty party]; *Laraway v. First Nat. Bk. of LaVerne*, 39 Cal.App.2d 718, 728-729 [where confidential relation exists one can act on presumption of absence of intent to defraud]; see further, *Anderson v. Thacher*, 76 Cal.App.2d 50, 70 and *Kornbau v. Evans*, 66 Cal. App.2d 677, 685-686.) We are not prepared to say that no other reasonable conclusion could have been reached than that, in its then setting, the proposal was sufficiently startling to put a prudent man in Davis' shoes upon inquiry. We do not have to.

The trial court was not required to find actual awareness on the part of Davis. For that the situation would have to have been that no reasonable deduction was open to the trial court other than that Rabin would have advised Davis of the memorandum's contents. We cannot so hold. Davis said that he knew about some conferring but not what it concerned. It was open to the trial court to consider that Rabin felt that he was working under Goodson and Hannam, that they were just exploring together, that absent a direction from Goodson and Hannam there was no need to lay details before Davis. The trial court let it be known that it was influenced by the fact that Westbrook had Rabin in court but never called him on this or the change of counsel point. It was entitled to draw inferences adverse to Goodson and Hannam."

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"Thus, Westbrook did not question Rabin on the topic of whether Davis had made known to him earlier than November 1965 that he entertained suspicions that Goodson and Hannam were fostering their own interests instead of his. The record indicates that Rabin was the subject of discovery proceedings. The trial court no doubt surmised that the process had produced nothing of that nature.

(*Masterson v. Pig'n Whistle*, 161 Cal.App.2d 323, 338; *Talbert v. Ostergaard*, 129 Cal.App.2d 222, 229; *Martinez v. Superior Court*, 7 Cal.App.3d 569, 576 (questioned on another point in *Mozzetti v. Superior Court*, 4 Cal.3d 699, 703).) Incidentally, it was Davis' testimony that he had not told Rabin what representations had been made to him by Goodson and Hannam. Further, Davis stated that until November 1965 he thought that the situation was "in good hands" (Goodson and Hannam's) and being taken care of, and that "everything was going perfect."

Goodson and Hannam urge that the trial court was bound to apply the rule that information gained by an attorney is to be attributed to his client. Their contention, however, is premised on the proposition that it was recognized by all that by then Rabin was Davis' independent counsel. The rule, of course, is patterned to such a situation. In our view it should not be applied to the situation wherein the party to be bound considers that the party claiming advantage of the rule is his primary attorney and that the attorney receiving the information is the "satellite" of the other. We cannot say as a matter of law that Davis should not have considered that Goodson and Hannam remained as his primary counsel at least until their overtures in November 1965 gave him an inkling that they were preferring their own interests to his. Davis testified, in effect, that until the break in November 1965 he considered that Goodson and Hannam remained as the so-called masterminds as to the on-going operations of the Custom Plan and as to its continuing efficacy, and regarded Rabin as their subaltern in charge of details and not as his independent counsel. The trial court

had the right to believe Davis.[27] Goodson and Hannam, in effect, argue that the trial court had to find as a matter of law that this belief was unjustified. We cannot say that this was required. The evidence shows that Rabin's association started out on the indicated basis. There were no specific events which should have signified to Davis that this pattern was not continuing. The tenor of Davis' testimony allowed the inference that Goodson and Hannam did not tell him that they no longer would act as his primary advisors and foreseers.[28] Davis testified that both worked on the 1961 renegotiation assignment, on an R. Bd. matter in 1962, and on his "foundation"; that there were a number of meetings, 1962 through 1965, of which, inferentially, Davis became aware, where Goodson and Hannam were present with Rabin, and some when Davis was present as well; that in 1964 Goodson and Hannam and Cuneo, on his behalf, discussed another renego-

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[27]On appeal Goodson and Hannam assume the belief. In the trial there was an unsuccessful attack. An obvious effort was made to get Kelley (with whom Davis dealt in the Mammouth transaction) to do so, but he would not testify that Davis had told him that Goodson and Hannam were no longer his professional advisors.

[28]It seems that when the Custom Plan was being worked out there was a tentative exploration of a discontinuance of the relationship, but Davis was emphatically opposed. The inference is that Goodson and Hannam acquiesced. One reasonable construction of this feature is that it fortifies the plausibility of Davis' challenged belief.

Goodson and Hannam flatly assume a termination of their professional relationship to Davis when Rabin commenced rendering services beyond the original audit project, as shown by his billings. This does not automatically follow. The reaction of Davis has got to be involved. Under a separate heading, Goodson and Hannam anticipate a contingent Davis argument to the effect that even if it were found, as a matter of law, that awareness of facts had put him upon inquiry, the statute of limitations was tolled as long as the attorney-client relationship continued, and they urge in opposition the assumed termination. Davis did not need to make the argument.

tiation matter. The business type contacts discussed in Goodson and Hannam's opening brief are not inconsistent with Davis' concept; rather, although not constituting legal services in a very technical sense, they fortify it. The reasonable mind could say that the appearance of things was such that Davis was warranted in his belief about Goodson and Hannam. Of course, again, Westbrook's declination to question Rabin on this subject (impressions left by Goodson and Hannam) was stated by the trial court, in effect, to be a strong influencing factor.

## ASSERTED RATIFICATION

The defense of ratification, which was rejected by the trial court (Finding 34), rests on the fact that Davis negotiated two royalty checks after the November 1965 date when he says he was alerted and commenced inquiry as to whether Goodson and Hannam were fostering their own and not his interests. One was dated April 22, 1966, and the other January 5, 1967. Cited was *Neet v. Homes*, 25 Cal.2d 447 which is keyed to rescission, a remedy which Davis ultimately did not pursue. Moreover, it is not the Davis-Custom contract which forms the chief basis for Davis' suit against Goodson and Hannam. It is the legal service-fee contract. Accepting the royalty checks does not necessarily affirm or ratify the latter agreement.

Incidentally, as between Davis and Custom, as shown by the correspondence, the difference in views was whether the checks were pursuant to contract or in restitution after a rescission. The trial court was warranted in taking the position that each side was protecting its own position and that neither had compromised his or its position.

## 631.8 RULING AND STOCK RIGHTS

1. *Procedural Aspects:*

Bearing in mind the nature of the pertinent evidence and argument in this area and the terseness of the ruling,[29] it must be considered that the issues covered in the Code of Civil Procedure section 631.8 motions involved both the questions of constructive trust on the stock of the minority shareholders and of stock rights, and that the original announcement of intended ruling was that there was no constructive trust and that all the stock rights agreements were valid. The ruling had to have been made on the premise that Davis had made a prima facie showing which entitled him at least to have a constructive trust imposed on the Goodson and Hannam 60 percent block[30] and that Davis would continue to so prevail which, of course, he did.

The announcement, of course, was preliminary and tentative; the judgment[31] was to be the "decision."[32] (4 Witkin, California Proc., (2d ed.) Trial, § 312, p. 3119, § 313, p. 3119, § 318, p. 3122, § 304, p.

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[29]For example, when Chodos wanted to know if 9 percent of Custom's assets as well as 9 percent of its shares were beyond Davis' reach, the trial court stated: "[The Employee shareholders] have made a motion for judgment of dismissal under section 631.8, and I have granted it."

[30]We do not have to deal with the ramifications which might have ensued had a constructive trust been imposed on all of Custom's assets.

[31]Whether this could have been executed as a final trial judgment as to separate parties while the trial proceeded with respect to the other parties (Goodson and Hannam and Custom, at first directly and then derivatively), we do not have to say.

[32]For awhile, at trial, Beardsley had the erroneous idea that there had been a "decision" which had put May out of the case. He had to shift to the position that the motion was under submission and that no post-motion evidence could be considered without a formal reopening of the issue.

3113.) It remained in abeyance because consideration of the proposed findings and objections, by minute order of May 26, 1970, was put off until the end of the case. The motions were under submission. This meant that the minority shareholders had no assurance that the trial court would not change its mind but that they were entitled to anticipate that no further plaintiff evidence would be received and considered on the matter unless on motion of counsel or by order of the trial court.

From March 16, 1970, to May 20 court tried the issue of whether Title to a constructive trust either on all of Custom or on Gunston and Hannan (40 percent block. The minority shareholders and their counsel did not participate. At argument the question of stock rights came up again. When Counts suggested that the minority shareholders, whose counsel were present at that part of the argument, should be dealt with evidence and argument on the question of the divestiture of their stock rights, it really was a request that the submitted Code of Civil Procedure section 631.8 motions be denied and that the minority shareholders proceed with counter evidence. The ultimate trial court action as to the employee shareholders (June 4) was to stand by the original dual grant in their favor. In due course this was covered by findings and judgment. The effect of the trial court's overall action as to May (June 25) appears to have been to sever the issues, stand by the grant of motion as to the constructive trust point, deny it as to the stock rights point, indicate its readiness to receive any evidence and argument May might have to counter Davis' showing, and, finally, when May declined to present any and sub-

mitted, make a full trial type decision that May's security right in Goodson and Hannam's stock and his purchase right upon its involuntary transfer were inoperative as to Davis.

2. *May's Stock Rights:*

The gravamen of May's appellate attack against the decision on the stock rights issue is that he did not have due process or a fair trial, or, in any event, the semblance thereof. Our consideration of these points follows:

(1) There is no assurance that the trial court did not give consideration to evidence which it received between March 16 and May 20, which had a bearing; and there are aspects of it which suggest that it would have.[33] The trial court never said it did not consider some of this. Beardsley asked the trial court "[if its] rulings [was] based on all of the evidence thus far," and it said, "Yes, it is."[34] Davis had made no motion to reopen, and the trial court, until this point, had given no indication that it was going to give attention to such matter. It should not have done so. Its proper action at the time was to have advised Beardsley that it would back off and rerule with only the pre-motion evidence as the basis, and then done just that, whatever might have been the result.

(2) The trial court irregularly made an oral statement of its intended decision out of court to only part

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[33]Davis's testimony concerning his contacts with May and detaching himself from intimations of illegal actions appearing in the testimony of Goodson and Hannam which May might have used in an unclean hands argument.

[34]The trial court may have meant that it had utilized the intervening evidence to confirm Davis' prima facie showing of right to a constructive trust against Goodson and Hannam, but it did not need this; and it did not say so.

of counsel which did not include Beardsley. If the announcement of an intended decision is going to be made in an oral statement, it should be "in open court in the presence of all parties who appeared . . . ." (Cal. Rules of Court, Rule 232(a).) The other method for making such announcement is by filing a written statement with the clerk[35] who mails copies to all parties. (Cal. Rules of Court, Rule 232 (a); 4 Witkin, California Proc., (2d ed.) Trial, § 312, p. 3119.) Carrying out this significant step in connection with this issue in this much deprecated fashion was a flaw in the operation of due process.

(3) The indication is strong that the trial court improperly prejudged the stock rights issue as to May which, in effect, it now had pending before it after its virtual section 631.8 denial; that it had made up its mind that May could not come up with anything that would alter its viewpoint; and that its statement of readiness to hear May's evidence and argument was merely a procedural gesture.

When the trial court asked Smith (who had just testified that the trial court had told him on the telephone that it was going to rule that all post-suit agreements were to be invalidated) whether it had indicated to it that that was the ruling or just an expression of intention, Smith stated that it was his recollection that "[the trial court] had made up [its] mind how [it was] going to rule and that [it was] going to protect the record by giving . . . Beardsley an opportunity to present argument or evidence"; and that it was his conclusion from what was said and how that "any such argument or evidence would be futile." Although

[35]We note that the trial court used this method subsequently.

later, when asked by Beardsley if it had "any difference of [*sic*] the statements . . . Smith," the trial court stated that "[it] didn't say [it] was going to definitely rule." The trial court never did disclaim the other portion of Smith's account. It is apparent that on June 25 Beardsley felt that it would be futile for him to have offered any evidence, although his abstinence may have been motivated partly by a desire to avoid a waiver of the added evidence point. " 'A trial judge should not prejudge the issues but should keep an open mind until all the evidence is presented to him.' [Citations.]" (*Hansen v. Hansen,* 233 Cal.App.2d 575, 584; see also *Webber v. Webber,* 33 Cal.2d 153, 158.)

(4) It is clear from the record that the trial court's judicial mood was affected by the telephone incident and its aftermath and the justifiable shock displayed by counsel. It became sensitive and self-conscious as evidenced by a series of remarks it made not only at the time but intermittently thereafter. We refrain from quoting or characterizing them. Those concerned are throughly familiar with them.[36] We simply point out that they suggest that the trial court was counter reacting to what it realized had been ill advised communications. It may not have been in the judicial frame of mind to afford the parties a fair determination. The unfortunate incident and its immediate aftermath were not conducive to a calm and deliberate adjudication. Determination of an issue without a fair hearing may constitute a denial of due process and reversible error *per se.* (*Spector v. Superior Court,* 55 Cal.2d 839, 843-844; *Estate of Buchman,* 123 Cal.App.2d 546, 559.)

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[36]The reporter's transcript depicts the difficulty of both court and counsel. (See pp. 5108 and 5121-5140.)

At least those results must have been the look of things. Not only the fact of but the appearance of a fair determination is an important factor in the operation of our judicial system and its ability to command the respect and confidence of the public. Although we have not given the details of the trial court reaction identified in footnote 36, we deem it necessary to refer to certain happenings to which we have given particular consideration on the appearance-of-justice point.

On June 3, 1970, the trial court advised counsel that it had indicated to Smith just in the hallway that probably it would rule in the afternoon, but it wanted to go over some more of the transcript. It then stated: "Let's adjourn now to tomorrow morning and I will give you an answer first thing in the morning.

"What I plan to do tomorrow morning is to make a ruling as to the matters that are before me now [which would include the re-raised stock rights issues] and direct Chodos to prepare the order, period."

So the expectations of all, obviously, were to receive an oral ruling in court with all present. Instead, as we have observed, the announcement of intended decision was made during the night to just some over the telephone. Then this further departure from judicial standards occurred: On June 4, at the outset, the trial court stated: "I would like to make a full disclosure as to what has taken place since court adjourned yesterday." It then proceeded to explain that it had telephoned Chodos and asked him about dates on the stock purchase agreements and discussed possible special masters; had called but not reached Beardsley (one very good reason for adherence to the rule of avoiding out-of-court contacts with counsel); and had then called Smith and told him in essence what it had

told Chodos. It then concluded: "Now, that, in essence, is what happened last night. I wanted you gentlemen to know this." Then, of course, the testimony of Smith was taken in connection with Westbrook's motion for mistrial, and it was made known that the trial court had expressed itself on the merits, made comments about some of the attorneys, and advised how it was going to rule and protect its record. Included was the remark, according to Smith, that "[it] would deny [making] the statement if it were quoted" but "[it] was convinced that Goodson and Hannam had taken . . . Davis."

"[O]ur system of law has always endeavored to prevent even the probability of unfairness . . . . [T]o perform its high function in the best way 'justice must satisfy the appearance of justice.' [Citation.]" (*In re Murchison*, 349 U.S. 133, 136.) *Murchison* is a criminal case, but the same principle has been expressed in civil proceedings. " 'The trial of a case should not only be fair in fact, but it should also appear to be fair' [citations]." (*Hansen v. Hansen, supra*, 233 Cal. App.2d 575, 584.) "[I]t is not merely of some importance but is of fundamental importance that justice should not only be done, but should manifestly and undoubtedly be seen to be done." (Hewart, Lord, *Rex v. Sussex Justices*, 1 K.B. 256, 259; see also *In re Gault*, 387 U.S. 1, 26; *Offutt v. United States*, 348 U.S. 11, 14; *Wong Yang Sung v. McGrath*, 339 U.S. 33, 42; *Lois R. v. Superior Court*, 19 Cal.App.3d 895, 902; *Gloria M. v. Superior Court*, 21 Cal.App.3d 525, 527.)

Davis argues that May waived the defects we have reviewed when he submitted the issue on June 25. We note the following: On June 4, when the facts had

come out, Beardsley stated that he thought that the trial court had disqualified itself by its conduct. He said that if the trial court set a date, he would be there, but that his motion would be to have "[w]hatever attack has been made on these agreements" "heard by another judge." On June 25, when the trial court called the matter, Beardsley stated that he was not certain how to proceed. He did not reiterate his prior conviction that the trial court was disqualified, and he did not move to have the matter referred to another judge. When, upon inquiry, the trial court affirmed that its June 4th ruling was based on all the evidence thus far, Beardsley said that he did not want to offer any evidence and would submit the matter of May's stock rights. Perhaps under some circumstances this action would have constituted a waiver of the claim of lack of fair trial or semblance thereof, but the trial court's conduct was a sufficiently fundamental departure from proper judicial standards to place it, when combined with the other errors, beyond the reach of this type of waiver. (*Shippey v. Peninsula Rapid Transit Co.*, 197 Cal. 290, 295; *Wuest v. Wuest*, 53 Cal.App. 2d 339, 345-346.)

3. *Purchase Rights in Employee Shareholders' Stock:*

The rights in which we are interested are the so-called options to purchase upon involuntary (though possibly voluntary) termination of employment. The rights of two are involved: Custom (right of first refusal) and the owner of the 60 percent block (right of second refusal). Because of this, Davis actually is making two types of claims. One is on a derivative basis for Custom (initially as contingent, but ultimately as adjudicated beneficial owner of the 60 percent

block) for the allegedly improvident surrender by the officer-directors of said right of purchase, accomplished by the July 28, 1969, agreement. The other is a direct claim stemming from the prerogative inherent in the 60 percent block and having as its basis chiefly the equivalent of a violative transfer of trust property to one having at least constructive knowledge. The freeing of the stock of this obligatory offer put the employee shareholder in a position to bargain for more than fair market value.[87]

For obvious reasons, Davis does not assert a lack of due process or of fair hearing or semblance thereof. He argues that the evidence, as a matter of law, does not support the finding (32) to the effect that from the standpoint of the employee shareholders the July agreement was made for an adequate considera-

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[87]There was some reference by both Chodos and Windham to a modification which, as to involuntary termination, changed the price for purchase by Custom or the owner of the 60 percent block from book to fair market value. Griffith spoke of about four modification agreements. Possibly reference was made to fair market value because this at least was what the employee shareholders could command. We are not sure if there were any such intervening agreements. If there were, it would have a tendency to emphasize the fraudulent aspect of these maneuvers. On remand it would seem reasonable for the trial court to explore the existence of any such intermediate revisions and any priority problem with respect to them. Market value generally is a much higher figure than book; Windham at one point asserted this to be the fact. A much more complex problem is encountered in establishing market, especially where transactions have been minimal. Another lawsuit would practically be guaranteed. The following citations might be of interest: *Norte & Company v. Huffines*, 288 F. Supp. 855; *Lassallette v. Parisian Baking Co.*, 110 Cal.App.2d 375; *Polinsky v. Vaughan*, 268 Cal.App.2d 183; *Piedmont Publishing Co. v. Rogers*, 193 Cal.App.2d 171; *S. C. Pohlman Co. v. Easterling*, 211 Cal.App.2d 466; 18 Am. Jur.2d, Corporations, §§ 219-221, pp. 747-750; 18 C.J.S., Corporations, § 403, p. 949; § 411, p. 991; Black's Law Dictionary deluxe (4th Ed.) p. 227 (book value) and p. 1123 (market value).

tion and without notice of the claims of Davis; and that, in reason, no other inferences could be drawn from the evidence than that the employee shareholders had knowledge of the constructive trust potential and that the sole or significantly major purpose of the July agreement was to protect themselves against and frustrate the recovery of Davis. However, the determination of these issues obviously is infected with the same judicial interregnum as pervaded the May matter. We note some counter reactive remarks. When the senior partner of Windham's firm, Montelone & McCrory, had indicated to the trial court his willingness to have it assigned to sit for all purposes on another case, despite Windham's then position that he had cause for a mistrial, it stated it was confused as to how it could act in such a schizophrenic manner. When Windham withdrew his motion for mistrial, the trial court stated: "I am glad your office got together . . . . [¶] You will see from . . . Smith's recordation of our conversation that even [he] didn't mention the employees not even this morning by his additions to the transcript. [¶] Isn't that right . . .? [¶] SMITH They weren't mentioned in the conversation your Honor, to the best of my recollection. [¶] THE COURT: You see?" Then, when it actually ruled, upholding the effectiveness of the July 28 agreement, it accompanied its ruling with the remark, "Because as long as we have two members of Monteleone and McCrory I don't dare antagonize them." If one of the stock rights issues is to be retried, the other should be too.[30] Under the circumstances we do not need to decide the question of law raised by Davis. However, we are of the view

[30]Code of Civil Procedure, section 631.8 motions may or may not be made again.

that the Davis position has considerable merit; so it is in no way unreasonable for the issue to be retried. Some treatment of the factors which support our viewpoint, for the benefit of the parties, is indicated.

Of course no monetary consideration passed from the employee shareholders in return for the advantage they gained from the surrender of the options. The consideration argued for (chiefly by Berry, but it must be considered that the others stand with him, because they suggest no other) is that a Goodson-and-Hannam-dominated Custom obtained a more productive grade of service from the employee shareholders than it would have if they remained concerned over the likelihood of having to lose their jobs and sell their stock at book value if Davis got control of Custom. This could amount to a modicum but yet it would be gossamer because the employee shareholders still had to remain concerned whether Davis could get a judgment holding the surrender ineffective as against him. There was no evidence that the efficiency of the employee shareholders suffered because of their worry.

Of greater significance is the point that the very factors argued in support of consideration show that the employee shareholders had an awareness of Davis' claim of entitlement to a constructive trust on the 60 percent block and of the sinister implications of the corporate control he thereby would gain. There was considerable independent evidence of knowledge of Davis' claims. Berry stressed the "lawsuit in the works" and the chance of a shift in control to Davis whom he did not trust; and Miller testified that he was upset because Davis was "trying to bother him." The trial court stated that the time element made the thing "look fishy" and that it had a "strong suspicion that

something not entirely above-board was afoot" but, in effect, it did not amount to substantial evidence. We do not necessarily concur in the latter evaluation of the trial court.

From the standpoint of Custom, the trial court would be comparing equities and certainly would be called upon to give heed to the dominant motive[48] of the employee shareholders—in light of the appreciation of Davis' goals, to protect themselves and frustrate him—and to the aspect of fraud against Custom as an entity. Berry was the only one who gave an indication of a preexisting desire to have Custom and Goodson and Hannam make concessions as to their purchase rights, saying that he had been making requests for removal of "strings" on his stock ownership; but his concern then apparently was over Custom "going public," which certainly was not a likelihood in July of 1969. There can be no question as to which of the motives we have looked at was dominant and which subordinate. It is also significant that it was only the right to purchase on termination that was fully eliminated in the July agreement.

With respect to the right ancillary to the 60 percent block, as noted, it was potentially, and ultimately became a part of the true "res" of the constructive trust.[49] The surrender of the right of purchase on the one hand and the corresponding gain of advantage on

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[48]Compare the situation in the tax field where with respect to business deductions "dominant motivation" is the standard applied. (*United States v. Generes*, .... U.S. .... [31 L.Ed.2d 62]; see discussion in 58 A.B.A.J. 517 [May, 1972].)

[49]For all practical purposes Davis abandoned the res-pierced veil theory when the trial court limited the constructive trust to the 60 percent block and he pursued his claims for surcharge damages, contract interpretation and reformation, and royalty accounting.

the other was the equivalent of a transfer of a trust interest.[41] The facts reviewed point toward a finding that the transferee was on notice that there was a claim of trust and that the relinquishment of the right was in betrayal of the trust obligation. Since, in fact, the constructive trust was imposed on the 60 percent block, under the circumstances, the transferees (the employee shareholders) would not gain a right of priority as against the constructive beneficiary of the trust (Davis). (Rest. 2d Trusts, § 288, p. 55; § 297, p. 74;[42] Civ. Code, § 2243; cf. Rest. 2d Trusts, § 286, and Comment b thereof, pp. 52-53.)

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[41]In this regard the disposition (constructive transfer) of the (property) right, which was without notice to Davis, came close to being a violation of the preliminary injunction issued by Judge Kurland, the existence of which was actually known of by two of the employee shareholders and should have been by the others.

[42]Section 288: "Transferee with Notice. If the trustee in breach of trust transfers trust property to a person who takes with notice of the breach of trust, the transferee does not hold the property free of the trust, although he paid value for the transfer." (P. 55.)

Section 297: "What Constitutes Notice of Breach of Trust. A person has notice of a breach of trust if (a) he knows or should know of the breach of trust, . . .

"Comment:

"a. *What constitutes notice.* A third person has notice of a breach of trust . . . when he knows facts which under the circumstances would lead a reasonably intelligent and diligent person to inquire whether the trustee is a trustee and whether he is committing a breach of trust, and if such inquiry when pursued with reasonable intelligence and diligence would give him . . . reason to know that the trustee is committing a breach of trust.

". . .

"c. *When a transferee is chargeable with notice of a breach of trust.* A transferee of property is chargeable with notice of a breach of trust, if [knowing the nature of the trust] (3) he . . . should know that the trustee is improperly deviating from the terms of the trust.

". . .

In a sense the July agreement could be considered a fraud against the court itself. Implicit in the trial court's main ruling was its recognition of the Davis version that Goodson and Hannam represented to him, in effect, that one of the reasons they were going to put purchase rights on the minority stock (but which they omitted to do originally as to both Humphrey and May) was to have a preexisting setup which would facilitate reverter when the time and conditions were appropriate. The effect of the surrender was to frustrate one of the benefits of the judgment which the trial court might (and did) render and the trial court's desire to make Davis the beneficiary of its equitable powers. This could, as well, be considered a violation of the spirit, though not the letter of Code of Civil Procedure section 1908.

The employee shareholders stress that upon examination by his own attorney, each asserted that when he signed the July agreement he did not have any idea that Davis was seeking to impose a constructive trust on his own stock. This hardly rules out either an awareness of Davis' undertaking to gain a constructive trust on Goodson and Hannam's stock and control of Custom or a concern as to discharge from employment and subjection to the requirement of the original purchase agreement. Rather it seems a studious avoidance of the subjects.

There is no merit to the contention of the employee shareholders that laches should estop Davis from as-

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"j. *Notice of legal effect of terms of trust.* When a transferee . . . should know the terms of the trust, he is chargeable with notice of the legal effect of those terms. . . .

"k. *Notice of a deviation from terms of trust.* If the transferee has notice of [the nature of the trust] and if he had used due diligence would have ascertained that the transfer is in breach of trust, he takes subject to the trust. . . ." (PP. 74-78.)

serting noneffectiveness of the July agreement. That agreement was executed long after suit was filed, and Davis only learned about its existence in a court proceeding before Judge Kurland in September 1969.

4. *Remand for Trial:*

Considering all of the problems attendant to these two segments of the case, it is preferable that they be remanded for retrial. The task of retrying them on a severed basis, although admittedly troublesome, will not be insurmountable. The dismissal of the employee shareholders' cross-complaint which the trial court encouraged as a concommitant of its favorable ruling should be set aside.

## CONTRACT INTERPRETATION-REFORMATION ISSUES

1. *Opposition on Derivative Basis:*

Davis' contract interpretation and reformation cause of action[48] was contingent. It was pressed against Custom because he did not get a constructive trust imposed on all of Custom's stock or assets. At this point, since it recognized that a Davis dominated Custom would concede his personal claims, the trial court, through the vehicle of intervention, put the minority shareholders into the position of making a defense for

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[48]The thought occurs that the interpretation-reformation issue might not be of much consequence if Davis' constructive ownership of 60 percent of Custom's stock holds up and he should exert the power he thereby would have to "recircle" the patent interest and the market potential back to himself and Hydra. However, regardless of what Davis might do in the future in that respect, the interpretation or reformation is an important item in support of the judgment to date, and would have a role in covering the situation while Davis, if he chose to do so, was processing what recycling he could achieve as a majority shareholder.

Custom on a derivative basis.[44] Goodson and Hannam were included as contingent[45] shareholders.

2. *Identification of Issues; Disposal of Uncomplicated Ones:*

The interpretation and reformation part of the judgment is epitomized in Conclusion 15. Without expressly saying so, some of the adjudication amounts to interpretation and some to reformation.

The first two items deal with the royalty percentage to be paid each quarter and with the time when the balance for the fiscal year is payable. As we understand it, defendants do not resist these adjudications.

The substance of the next two items therein, which is the subject of contest, pertains to the base on which royalties are computed. Serious problems are involved, and detailed discussion will follow.

The next item *affirms*[46] the contract language to the effect that "net profit" for royalty computation is "prior to deductions for . . . State franchise taxes," as against a possible defense-asserted modification established by conduct.[47]

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[44]The minority shareholders make the point that they did not have the opportunity to defend against the interpretation-reformation contentions because the trial court went ahead without them after granting their motions under Code of Civil Procedure, section 631.8. However, their court status with respect to the interpretations-reformation was not in their personal capacity, but as defenders in a derivative sense, which the court enabled them to do as interveners.

[45]The contingency, of course, being a successful appeal.

[46]Thus, it is neither a reformation nor interpretation, but merely a rejection of a defense claim of modification through conduct.

[47]The trial court did hold that Davis had waived the right to have erroneous franchise tax deductions eliminated from royalty computations prior to September 30, 1966. Davis does not challenge this ruling.

The next item deals with the imperviousness of Davis' royalty right to the narrowing of any patent or to the invalidation of any patent (unless of each and every) and the duration of Custom's obligation. Discussion on this court's interpretation will follow.

The ensuing item has to do with the preclusion of deductions which are not for ordinary, necessary, and reasonable expenses. No serious objection is interposed to this adjudication.

The final item calls, in effect, for the addition to the contract of a clause saying that in the event of any royalty default by Custom, the assigned patent rights shall revert to Davis. We find no substantial evidence in the record to support the proposition that this was to be included in the contract. The various references by Davis to representations on the part of Goodson and Hannam with respect to a purposeful default as a recapture device for Davis clearly related to actions dehors the contract which Goodson and Hannam could take on behalf of Davis. Davis testified that "[Goodson and Hannam] would do it [cause a reverter] by this default [process] which they didn't have to include [in the contract]."

3. *Some Defense Points*

Before considering the reversed issues, we cover some defense points of opposition[48] to this phase of the

[48]Such as lack of substantial evidence; inherent improbability of Davis' version because of threat to concepts of bona fide sale and common control; necessity of false representation. As to the latter, we feel that, considering the attorney-client relationship and the high professional duty attendant to it, Goodson and Hannam's presentation of the documents to Davis without disclosure of their variations from the anterior understanding (inferable from Davis' testimony) and with his unquestioning acceptance of the Hydra fragmentation as a demonstration to them of his trust, was sufficient.

case. Most have been rendered moot by the rulings made and to be made which for all practical purposes render only interpretive relief to Davis with respect to the patent assignment contract. However, a few deserve brief consideration:

(1) Contention that there is no finding that there was any mutual contractual intent between Davis and Custom antedating the written contract. There is none specifically, but the following exists by implication: Goodson and Hannam had to be acting for and so were the "mind" of both Davis and Custom, in formulating the intent for each. What they said in their representations, in effect, amounted to the mutual intent which was supposed to find expression in the written contract.

(2) Contention that there was no evidence that Davis did not know what was in the written contracts or that he acted reasonably in not reading them. Our analysis: Davis' testimony that he did not check the contract as to certain aspects allowed the inference that he did not check it at all. As to Davis' reasonableness in not reading the contract, it is implicit in the "reliance" finding that Davis had complete trust and faith in Goodson and Hannam and had put his renegotiation and tax problem fully into their hands. There is ample support in the record for this. For example, Davis testified that he was accustomed to following the advice of his attorneys without question; that he always used counsel, did not "second-guess important matters," that he "left it [the Custom Plan] up to them [Goodson and Hannam]." The trial court was justified in determining that Davis did have implicit reliance in Goodson and Hannam and was not unreasonable in failing to check the contract against the oral representations.

(3) Contention that Davis was guilty of laches in pressing his claim for contract interpretation and reformation. This seems inapplicable to the court action that we have sustained. In any event, the same factors of trust set out above plus the evidence that Davis thought everything was perfect until late 1965 (discussed in another segment of the opinion) meets the objection.

(4) Contention that the minority shareholders relied on the contract, and it would be unfair to them to reform it or give it a liberal interpretation. Discussion: We found nothing in the record to indicate that the employee shareholders became familiar with the wording of the contract. There is no particular reason why the employee shareholders should have. Berry testified that although Davis told him of Custom being independent and a recipient of a one-half patent interest from (Davis), "he never discussed anything about the contract with [him]." The others did not allude to the contract. Although May perhaps had some knowledge of the contract, he gave no indication that he relied on any aspect as to which relief to Davis is being sustained by us.

(5) Contention that Davis is not entitled to equitable relief by way of contract interpretation and reformation because he, according to Interveners, secured his switch patent under false pretenses (unclean hands). We discuss this subject more fully later. Suffice it now to say that Interveners do not have a close enough connection or strong enough interest or show sufficient likelihood of damage to warrant the court expending the judicial time it would take to make a determination as to the validity of Interveners' claim. A complaining party has to be injured. (*Germo Mfg. Co. v. Mc-*

*Clelland*, 107 Cal.App. 532, 541.) Also it would seem that this defense would not be available under the *Clark v. Millsap, supra*, 197 Cal. 765 philosophy. Moreover, the switch patent is just one of three. It was fortuity that it turned out to be the one which is sustaining Custom's activities.

4. *The Royalty Base*

On this subject we have concluded: (1) That the circumstances do not permit a reformation of the patent assignment contract to make it provide that Custom shall pay royalties on 100 percent of what it processes. (2) That there is no evidence to support a reformation making the related-to-invention (instead of the embodying-the-invention) concept applicable to the gross measure for royalties. (3) That, adhering to the present contract provision for payment of 65 percent of net profits from activities related to the inventions, there is no evidence to support a reformation providing that Custom never will engage in activities except those related to the inventions unless Davis consents. Our analysis follows.

Paragraph 5(c) of the judgment (¶ 15(c) of the conclusions) provides, in effect, that the royalty base clause in the patent assignment contract (part of paragraph 5 thereof) should be reformed. The adjudication rests on the premise that the contract clause was not in accord with the anterior understanding between Davis and Custom. We have previously considered how any representations of Goodson and Hannam to Davis would be evidence thereof.

The contract clause, as we read it, provides that the royalty base shall be 30 percent of the gross selling price of all products (1) manufactured under

any of the processes covered by the patent applications or (2) embodying any of the inventions covered by the patent applications,[49] but that payments shall not exceed 65 percent of net profits defined as those from activities related to the invention. It goes on to provide that if Custom "has profits or losses from activities not related to the invention, then the net profits from . . . activities relating to the invention shall be separately computed as if [it] were the sole activity. . . ." The contract contains no restriction on Custom processing unrelated items. This wording shows no recognition of a concept of restriction subject to an exception of permission by Davis and the possibility of such only on condition that royalties be paid on the allowed unrelated items.

The judgment clause reads: "(c.) In computing its . . . net profits,[50] Custom shall include all of its . . . net profits . . . from all of its . . . . activities."[51] This appears to set a broad "net" royalty base—everything sold whether related to the inventions or not. However, in light of wording in judgment clause 5(d), of language in finding 26 (d) upon which those two judgment clauses rest, and of the trial position taken

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[49]We have broken up a single compound phrase into two. See reference infra to these elements earmarked in fn. 59.

[50]The clause deals with gross sales as well. For simplicity's sake we handle the problem with the base which the parties used. The apparent measuring inconsistency discussed elsewhere is not significant here.

[51]The language of the clause is "manufacturing and selling activities." The descriptive words are understood in our discussion.

Paragraph 5(f) dealing with duration of the royalty obligation, twice makes reference to "Custom's obligation to make payments . . . based on 100% of its . . . net profits." This repetition, we feel, does not serve to fortify 5(c) against the weakening factors we discuss shortly.

by Davis, 5(c) must be construed differently (with some straining) or modified in its language.

Judgment clause 5(d) says, "Custom shall not engage in any . . . activities unrelated to the inventions . . . , or *otherwise* not subject to payment . . . except with Davis' consent." (Emphasis added.) "*Otherwise* not subject to payment"[52] suggests that "activities unrelated to the invention" *also* are not subject to payment.

Finding 26(d) reads:

"26 . . . . Goodson and Hannam [represented that];

". . .

"(d) The payment formula would provide for the payments . . . to be . . . computed on the basis of . . . activities related to any of the inventions . . .; Custom would never engage in any . . . activities . . . except those related to . . . the inventions . . . (except with Davis' prior consent); . . ."[53]

In the second cause of action of the third amended complaint, Davis alleges that "[h]ad the . . . arrangement [in December] conformed to the representations made by . . . Goodson and Hannam, [it] would have included . . . the following . . .: . . . Custom would not engage in any . . . activities unrelated to the in-

[52]It is not clear what circumstances other than unrelated-to-the-invention would make a given item not subject to payment.

[53]There follows this phrase: "[*A*]*ccordingly,* Davis would always be entitled to receive payments based on 100% of Custom's net profits . . . ." (Emphasis added.) Clearly this is simply an observation (and inaccurate at that—because Davis might give a consent not conditional upon Custom paying royalties) of what would follow from a contract which read in accord with the finding.

ventions. . . . Further, . . . Custom would be obligated to make payments . . . based on . . . the . . . net profits . . . from . . . all products [processed] by [it]; including . . . products embodying or related to the inventions . . . , all component parts of such products, . . . and all products [processed] with . . . techniques . . . or equipment developed by . . . Davis."

In oral argument to the trial court, Chodos stated: "[W]e will stipulate that [Custom does not] have to pay on hula hoops and mattresses and garments that they manufacture. What we are claiming is [it has] to pay on all their belleville spring and sensing device actuated switches, which is 100% of [its] production." The following day Chodos summed up his contentions: "[Custom should pay royalties] . . . on all sensing . . ., actuating . . ., or combined sensing and actuating devices[;] . . . all products heretofore sold or manufactured by Custom fall within that category, and . . . no products are to be made in the future by Custom which fall outside that category without . . . Davis' express consent."

At another time he asserted that it was established by Davis' testimony and to be inferred from Custom's conduct (payment of royalties on entire production for about 8 years) that the oral understanding had been that "Custom would never go into the business of selling products outside of the agreement without Davis' prior consent."

On June 23, 1970, the trial court filed a memorandum entitled "INTENDED RULINGS RE INTER-

PRETATION AND REFORMATION OF AGREEMENTS." Part of it referred to the matter of the base for royalty payments. The format was to quote a point urged by Davis and to give a "tentative ruling." Thus, although each concept initially was that of Davis, any that were granted became that of the trial court. The pertinent one is, "Plaintiff's Point 1: 'The agreements should be construed to mean that Custom's obligation . . . extends to profits earned from all of its products . . .; *conversely*, that no products are to be [processed] which are not subject to payment . . ., except with the consent of Davis.'

"Tentative ruling: GRANTED." (Emphasis added.)

An accepted meaning of the adjective "converse," of which "conversely" is the adverb, is "reversed in order or relation" (Webster's Third New International Dict., p. 498). By the use of the adverb Chodos has the trial court saying, as it was put in the finding, that no products are to be processed which are not subject to payment (because related to the inventions) and so Custom's obligation extends to profits from all its products.

Thus, it appears that Davis, from pleading through proposed findings, was thoroughly committed to the concept that royalties were to be payable on profits from activities related to the inventions and that Custom was not to produce any others without Davis' consent.[54]

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[54]Compare situations where theory on mixed questions of law and fact cannot be changed on appeal (*Estate of Wester-*

(This footnote is continued on next page)

It was not until the proposed conclusion was composed that the 100 percent royalty base was set out as the dominant proposition[55] with a restriction on production of any other item (5(d)) being, as Chodos puts it in his brief, "largely ancillary." Probative findings control the conclusions which go into the judgment. (4 Witkin, California Procedure, Trial, § 346, pp. 3147-3148, citing *People v. Reed*, 81 Cal. 70, 76; *Robinson v. Raquet*, 1 Cal.App.2d 533, 541, and *Hunter v. Sparling*, 87 Cal.App.2d 711, 721.)

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*man*, 68 Cal.2d 267, 279; *Carmichael v. Reitz*, 17 Cal.App.3d 958, 969; *Goodwin v. Wolpe*, 240 Cal.App.2d 874, 878-879) and where findings must adhere to the issues as put in the pleadings and trial. (*Crescent Lumber Co. v. Larson*, 166 Cal. 168, 171, and *Barnhart v. Blackburn*, 137 Cal.App. 240, 242; see also: *Trafton v. Youngblood*, *supra*, 69 Cal.2d 17, 30-32.)

[55]If there had been a basis for holding that the contract should have provided that royalties be paid on 100 percent of processing, and also that no items unrelated to inventions be produced, it might be considered that an attempt was being made to set a form of liquidated damages for violation of the production restriction. It is doubtful that such a damage provision could have prevailed. It would not have been a true measure of damages. This is so because as many related items as nonrelated items might not have been marketable. Moreover, Custom might have produced patent related items with a lower expense ratio, so that its net might have been higher. It would have been necessary for the trial court to have taken evidence on what would have been the most patent related items that Custom could have marketed and on whether, if it had not branched out into nonrelated items, it could have produced the related items at a lesser cost. Damages apparently would have been for royalties on whatever additional patent-related items could have been produced at a net calculated on the constricted operations, plus any increase in royalties on the actual patent-related production based on the difference between the actual net and the hypothetical net.

Also of interest is testimony of Goodson and Hannam which indicates that it was their feeling that if Davis got royalties on nonrelated items and the combined royalties exceeded 100 percent of Custom's profits from its production related to the invention, this circumstance would frustrate the goal of the Custom Plan; but they had nothing to base this opinion on.

Thus, the 100 percent royalty base is out, and for purposes of the balance of this discussion we assume a judgment clause consistent with finding 26(d).[56]

There are two areas wherein the trial court found that the anterior "mutual intent" (as allegedly shown by purported Goodson and Hannam representations) called for a change in the structure of the patent assignment contract. One change would be the application of the related-to-invention concept to the gross measure. The trial court finding speaks of calculating payments not on "the . . . sale of devices . . . embodying the inventions . . ., but . . . rather . . . on the basis of . . . activities related to . . . the inventions . . ." The other change would be the addition of the provisions that Custom would never engage in activities except those related to the inventions, as against the intimation of the contract that there might be production of unrelated items as of right, as to all of which no royalties would be payable.

We found no evidence to the effect that Goodson and Hannam represented to Davis that the gross measure would be on sales of items related to the inven-

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[56]Perhaps if judgment clause 5(c) had not been weakened by judgment clause 5(d) and Davis had not committed himself to the concept of finding 26(d), and there was no evidence to support finding 26(d) and some to support judgment clause 5(c) (and there was a modicum, such as Davis' testimony that Goodson and Hannam said that "the objective . . . was to get all they could in Custom . . . that would come back [to him] as a capital gains dollar. . . ." that Goodson and Hannam's explanations to him made him think originally that all of Custom's profits were to be paid to him, that he was led to believe that Goodson and Hannam were going to run Custom for "value received," that the idea always was of optimizing the returns for him; and the record of payments on 100 percent of production for about 8 years), we could direct the inclusion of a replacement finding and uphold judgment clause 5(c). However the posed negation is evanescent.

tions. Thus, to the extent that finding 26(d) suggests that the gross formula should so provide, it is not supported. Further, we found no evidence that Goodson and Hannam represented to Davis that Custom would never engage in activities except those related to one or more of the inventions except with Davis' prior consent. Rather, there are a few expressions from Davis suggesting that he anticipated there would be some unrelated activities.[57] Davis argues that the payment record shows a contract construction for the restriction-permission postulate (rather than a failure to meet an anterior understanding). However, there is no equivocal language to a construction of which this conduct would apply. Amendment by conduct is not argued, and just the payment record would be a too fragmentary support. In any event, the only court finding is based on a differing anterior understanding. This finding, as our discussion indicates, is not supported by the evidence.

As a practical matter, Custom's activities under the patent assignment contract as it exists in these respects, will be regulated by Davis under the power of his control through stock ownership;[58] and also the contract must be considered as subject to a covenant

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[57]Davis said in "one of his [Cook] affidavits" that "to plan . . . for the probability that other products might be evolved, . . . the business operation was split up into several corporations. . . ." (Probably meaning both the Hydra fragmentation and the Custom assignments.) He testified that a start had been made on production for commercial uses as against military and when Custom came along, basically it took these over. He indicated that he was aware that Custom was engaging in independent research.

[58]For that matter Davis might soon institute action leading toward an abandonment of the Custom Plan and a winding up of Custom subject to the rights of the minority shareholders. We offer no intimation as to what the extent of these would be.

of good faith which would require the processing of sufficient products related to the inventions to keep Hydra out of renegotiation problems and bring Davis reasonable amounts of capital gain income. (*Redke v. Silvertrust, supra,* 6 Cal.3d 94, 100; *Brewer v. Simpson,* 53 Cal.2d 567, 588-589; 1 Witkin, Summary of Calif. Law, Contracts, § 242, pp. 271-272.)

It must be recognized that not having a reformation calling for royalties on 100 percent of production or restricting production absent consent, causes some problems to remain upon which it is not appropriate for us to pass since the trial court never really met them. We simply highlight ones we see; there may be others.

1. Whether there is, in the contract wording, a difference between the royalty bases for gross and net (the net clause might be construed as saying, "*so* related," referring back to the two descriptive elements of the gross measure),[50] and, if so, whether such difference should remain. Goodson and Hannam testified that they did not recall if a difference was intended.

2. What is the effect of the use of the term "inventions covered by the applications" (Goodson and

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[50]See footnote 49, *supra.*

Westbrook's trial contention (for Goodson and Hannam) as to the proper construction of the contract was that essentially Custom's obligation was to pay royalties only on the processing of products which were strictly within the scope of (not just related to) the patent, and that the "related-to" language meant spare parts and test reports and possibly products not technically infringing but so close in form and function as to be clearly derived from the patent. He gave the rather weak excuse, to explain away the past conduct argument of Chodos, that a gradual change in production kept Custom from realizing that some of its products had not called for royalty payments.

Hannam did not seem to know why it had been used); and, possibly, whether any claims in Davis' applications were not included in the patent award. (If so, under *Zenith Corp. v. Hazeltine* (discussed, *infra*) 395 U.S. 100, and the sound part of *Automatic Radio Co. v. Hazeltine* (discussed, *infra*) 339 U.S. 827, there should be no legality problem.)

3. Possibly, what the term, "related to the inventions," means, and what the nature of Custom's products is and has been since September 30, 1966.[60] It might be noted that Goodson and Hannam said that they had not discussed with Davis who would make such determinations; that Davis might bring the issue up under his audit rights.

5. *Duration of Royalty Obligation:*

With respect to the duration-of-royalty-obligation problem, we note the following clause in the contract: "6. The payments on said purchase price shall be paid for so long as the patents . . . and . . . improvement patents shall be in existence and shall terminate on the expiration of such patents and improvement patents."

Finding 26(c) reads in part as follows: "[T]o induce Davis to enter into such agreements, Goodson and Hannam [represented that] . . . even if one or more of the patents[61] should expire, or . . . be declared invalid or limited in scope, such events would not affect Custom's obligation to make the . . . payments

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[60]It would be considered, no doubt, that Custom had waived any adjustment prior to this, if one were due, as was considered for Davis with respect to franchise tax deductions.

[61]Thus, evidently referring to each of the three patents, one of which was dealt with in each agreement, showing the integration of the three agreements into a single whole.

. . . , so long as any of the claims[62] of any of the . . . patents or . . . improvement patents . . . remained in effect. . . ."

Judgment clause 5(f)[63] reads in part as follows: "Custom's obligation to make payments to Davis . . .[64] shall not be affected by any decree[65] limiting the scope of . . . or declaring invalid any patent . . .; but Custom's obligation . . . shall continue so long as any claim of any patent or improvement patent . . . is in effect."

It will be noted that the finding and conclusion do not provide for an interminable obligation as defendants seem to conceive when arguing that only the sale of a full patent interest will support such. We have found no testimony in the record, even from Davis, establishing that Goodson and Hannam specifically made a representation to Davis as set out in finding 26(c). However, there was testimony that Goodson and Hannam represented that the Custom Plan was being tied into "ongoing patents which would make [the] program run into the future . . ."; and that they "had drawn the contract . . . in such a way that the patent improvements would . . . provide that [the Custom Plan] would continue for some considerable time more

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[62]Used in the patent law sense wherein a single patent will likely embrace several claims often reduced from the number of claims specified in the application as being the invention.

[63]Paragraph 15(f) of the conclusions corresponds.

[64]The omission is a reference to the base of "100 percent of . . . gross sales . . . or net profits." Under our ruling with respect to the royalty base, these references will no longer be appropriate.

[65]In light of the trial court's ruling on the cross-complaint, what is in contemplation obviously is a decree obtained by a third party.

than the first patent. . . ."[66] Davis also testified that he was led by Goodson and Hannam to understand that "the objective of the [Custom] plan" was to have "all they could . . . come back [to him] as a capital gains dollar"; to "[optimize] the return" to him; that they were getting him the most returns that the government would allow without hurting the Custom plan, "all that was possible." Anyway, we see this feature of the judgment as an interpretation rather than a reformation, and actual representations are not essential. The finding need not have been so expressed.

The tenor of the representations and the clear implications that the three contracts were, in fact, a single whole,[67] taken together as the surrounding circumstances (Civ. Code, § 1647; Code Civ. Proc., § 1860; *Pacific Gas & Elec. Co. v. G. W. Thomas Drayage, etc. Co.* 69 Cal.2d 33, 42-43; *Lee v. Springer Laundries, Inc.*, 8 Cal.App.3d 1003, 1006), support the proposition that the language of the contract does not mean that there was a separate royalty obligation for each patent, or that all the patents had to remain in existence[68] for the royalty obligation to remain ex-

[66]There was testimony that Custom had obtained an improvement patent after 1957, and attorney observations suggested that there were others, perhaps obtained by Davis. In any event, under the contract, improvement patents were to be mutually enjoyed.

[67]There was, of course, a clear basis for the trial court considering that there was but a single program, despite the formation of three separate companies and the composition of three separate contracts, on the theory that that arrangement simply was a device for tax advantages along the lines of the fragmentation of Hydra into seven units.

[68]Defendants appear to be stressing the difference between all patents having to be simultaneously in effect for the royalty obligation to persist as against the concept of only one, no matter how narrowed, having to be effective even though it is not one to which Custom production currently related. We see no

tant, or that any patent had to retain its full scope. The language of the final phrase, read in light of the mentioned circumstances, to the effect that the royalty obligation would not terminate until "the expiration of such patents and improvement patents" makes room for the trial court's interpretation that the obligation "shall continue so long as any claim of any patent or improvement patent . . . is in effect."

Defendants urge that a broad royalty base would be illegal and cannot be sanctioned. Presumably they would urge the same as to what the discussed duration-of-royalties-interpretation would bring about.

We do not conceive that an agreement to pay royalties in return for the assignment of a one-half interest in a group of patents at an unfluctuating percent, even though the assignee may process products under only one or even as long as only one patent or improvement patent is extant, though narrowed in scope, is illegal under *Zenith Corp. v. Hazeltine*, 395 U.S. 100. In fact, *Zenith*, as we see it, would support the broad royalty base concept in our case if the evidence had shown that it had been agreed upon. In *Zenith* it is made clear that there is no ban against the assignor and assignee serving their mutual convenience by basing royalties on the sale of all of the assignee's products irrespective of its use of the patents. The *Zenith* injunction did not prevent this. It pertained only to the situation wherein the patent monopoly is used as a lev-

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reason why the trial court could not adopt the position that the understanding in December 1957 was that one patent was enough to sustain royalty payments. For one thing, there is no question but what Goodson and Hannam had the viewpoint that one patent was sufficient to support the execution and implementation of all three contracts. Incidentally, this is further demonstration that they were considered one integrated deal.

erage to extract a broad royalty condition from an unwilling negotiator so that the result is collection of royalties not for the potential use of the invention but for selling articles not within the reach of the patent. The patent owner does have the privilege to exact royalties as high as he can negotiate with a freely acting prospective assignee. In *Automatic Radio Co. v. Hazeltine*, 339 U.S. 827 (overruled by *Lear, Inc. v. Adkins*, 395 U.S. 653, on the estoppel ground only) the provision for a broad royalty base was proper because the parties simply chose, mutually, a convenient method of fixing the business value of the privileges granted. Clearly, if Goodson and Hannam had been acting forthrightly, considering the ostensible object of the Custom plan and Goodson and Hannam's position as the "mind" of each party, Custom was not resisting the formulation of an agreement which would call for it to make royalty payments in accord with the indicated interpretation as a convenient way to measure the value of the patent interests assigned to it; and Davis was not using a monopoly leverage to force Custom into an agreement it was reluctant to make. All this seem particularly sound in light of the various provisions of start-up help which, themselves, though not so specifically designated, could be viewed as consideration for Custom's commitment to pay royalties on the basis indicated. (See: Alderman, *An Antitrust Decision: Lear v. Adkins* (Jan. 1972), 58 A.B.A.J. 45, 46-47.)

## SURCHARGE DAMAGES

1. *Theories of Recovery by Davis:*[69]

There is no problem of legal support for damage items as to which a theory for direct recovery is applicable such as that part of some awards represent what would have been royalty, that dividends and cash redemptions are a fruit of the "res" of the constructive trust (the 60 percent block), or that manipulation of the salary payments or of the Denes expenditures were a breach of a professional promise. However, there is a question about a pro rata personal allocation of strictly derivative recoveries. We feel that the judicial action was logical and is supported by a line of respectable authority. Generally, the policy is to prevent unjust enrichment and avoid multiplicity and circuity of action.[70] (*Perlman v. Feldmann* (2d Cir. 1955) 219 F.2d 173, 178; *Norte & Co. v. Huffines, supra* (S.D.N.Y. 1968) 288 F.Supp. 855, 865 [follows general rule of not by-passing the corporation, but lists various exceptions, among them protection against dissipation of corporate recovery by management, citing

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[69]It would seem that Davis might have sought but did not seek a retention of jurisdiction by the trial court to give him indemnity recovery against Goodson and Hannam to the degree he might be unsuccessful when and if, as the majority shareholder of Custom, he ultimately took steps to secure a reassignment of the patent interest and acquire the Custom enterprise by having Custom purchase the stock of the employee shareholders and by himself, through negotiation, purchasing the stock of May, a step the decision in *Redke* appears to approve. The indemnity concept might also apply to any losses and expenses suffered by Davis in a battle with the minority shareholders over other rights or obligations not asserted as a theory in the suit or pressed in this appeal.

[70]This is what the trial court had in mind. At one point, it referred to "the corporate derivative claim [of Davis]" and stated, "Now, what we have done by this order . . . is shortcut that circuitous route."

*Backus v Finkelstein*, 23 F.2d 357]; *Amen v. Black*, 234 F.2d 12, 23; *Geltman v. Levy*, 207 N.Y.S.2d 366, 369, citing *Weinert v. Kinkel* (C.A.N.Y. 1947) 71 N.E.2d 445, 446; *Joyce v. Congdon* (Wash. 1921) 195 Pac. 29, 30; *Brown v. DeYoung* (Ill. 1897) 47 N.E. 863, 866; *DiTomasso v. Loverno*, 293 N.Y.S. 912, 918; *Eshleman v. Keenan* (Chancery Ct. Del. 1937) 194 Atl. 40; *Keenan v. Eshleman* (Del. 1958) 2 Atl.2d 904; *Johnson v. American General Insurance Co.* (D.C. 1969) 296 F.Supp. 802, 809-810, citing *Bellevue Gardens, Inc. v. Hill* (D.C. 1961) 297 F.2d 185; *Young v. Columbia Oil Co.* (W. Va. 1931) 158 S.E. 678; 69 Harv. L.Rev. 1314 [Note, Individual Pro Rata Recovery in Stockholders' Suits]; cf. *Sutter v. Gen'l. Petr. Corp.*, 28 Cal.2d 525 [shareholders considered to have a nonderivative claim]; *S.E.C. v. Manor Nursing Centers, Inc., supra.*) We discuss in detail only those awards which we feel were fairly controversial or in error.

2. *Attorneys' Fees For the Personal Defenses of Goodson and Hannam, May, and the Employee Shareholders:*

We have concluded that these were properly included in the surcharge damages awarded against Goodson and Hannam. There was no statutory pretext for the employee shareholders. We do not consider that Goodson and Hannam or May qualified under Corporations Code section 830(f). The chief claim against Goodson and Hannam was for breach of professional duty. This was involved as well in the Denes investments and the May consulting fees. The pursuit of a constructive trust on the May stock was on the theory of joint enterprise with Goodson and Hannam.

3. *May's Consulting Fees:*

The evidence was conflicting on this subject. May's experience and record in the sales field was brought out together with his assertions that he considered himself as available for consultation and capable of rendering some assistance and that "when . . . something came up in selling that they thought [he] could be of assistance to [he] was called." However, upon examination by Chodos, May conceded that it was he who had proposed that he get a salary, that "[he did not] have any particular duties," and that he did not give Custom's management any indication of how much time he would spend.[71] May testified that the decision for him to get consulting fees was in 1966, which could have been after the Keatinge demand telephone call, and that he started getting the fees in January 1967 which, of course, was after the suit was filed. We cannot say that the trial court had no basis for finding that the consulting arrangement really was not genuine[72] and was not worth to Custom anywhere near the sums paid over to May.

4. *Attorneys' Fees For Custom and Interveners:*

The situation, we feel, should be viewed from this standpoint: Initially, the contingent owner and then in midsuit the constructive owner of the 60 percent block, Davis, in his independent and separate capacity as the patent assignor, was suing Custom to have the pat-

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[71]At one point, when Beardsley pointed to May's record and availability for consultation, he further stated that, if the trial court need it, he could put on some testimony about conferences with salesmen; but this was never done.

[72]On June 3, 1970, the trial court made an observation to the effect that from May's evidence there was nothing to show that he had anything more to do with Custom except to be its angel.

ent assignment contract interpreted and reformed and also to collect royalties based on contract meanings as contended for.[73] In face of this, existing management, whose power was being sought by Davis, on its own, put up the first resistance. Then, when the powers passed under court control favorable to Davis, the minority shareholders (and Goodson and Hannam under the contingency of reinstatement), on a clearly derivative basis (court sanctioned through the allowance of intervention), resisted the contentions of Davis. Ideally, there should have been court control of the matter of counsel fees from the outset. The typical derivative situation should have prevailed whereby disputing shareholders finance their own resistance[74] when the corporation fails to act and at the close of the litigation, on the premise that they have protected rights of the corporation, apply to the court for reimbursement of reasonable fees from corporate funds. (*Fletcher v. A. J. Industries*, 266 Cal.App.2d 313, 322-325; *Mann v. Superior Court*, 53 Cal.App.2d 272, 280-281; 1 Ballantine & Sterling, California Corporation Laws, (4th Ed.) Directors; Management, § 89, p. 162.) At that point the court has considerable discretion. Where it feels that unsuccessful opposition was unwarranted, it can disallow the request *in toto*. Where

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[73]We do not include Davis' quest for a constructive trust on all the assets of Custom. Opposition to this essentially was the role of Goodson and Hannam and the minority shareholders, because the Davis theory was that these were personal assets to be reached through the piercing of the corporate veil. It was really for them, not for Custom, to assert the corporation's integrity and then to defend against the imposition of a constructive trust on the stock they owned. For a time, the claim for rescission had to be considered, but it was abandoned in amended pleadings.

[74]Fundamentally, this is the position in which the trial court put the interveners.

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the derivative resistance is successful in whole or in part usually an appropriate allowance is made.

Interveners cite *Olson v. Basin Oil Co.*, 136 Cal. App.2d 543. This was a case where a minority shareholder was attempting to have the court preclude the corporation from having counsel, which the majority shareholders (through the board of directors) wanted it to have.[15] Nonetheless, the policy factors seem applicable to the situation where the minority shareholder wishes the corporation to have counsel.

In the instant matter, the trial court, we feel, had the right to render a judgment against Goodson and Hannam as the ones primarily responsible for causing Custom to pay fees out to its attorneys. This could be for any amount of the fees which did not represent legitimate service to Custom in the area of contest involving it and also for any amount it felt was not warranted for services within that area. It must be assumed that the trial court concluded that no fees were warranted for the derivative defense in light of the fact that its judgment favored Davis all the way.

We are reversing this in part. This means that the question of fees for the attorneys who represented Custom initially and for those who represented the interveners should be reexamined. Clearly but a small amount of the very substantial fees paid to Mitchel, Silverburg & Knupp can be considered as allocable to the limited items of damage which we hold are subject to our reversal. But some of their preparation may have related thereto. This the trial court should consider. To

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[15]This is true also of *Suburban Water Systems v. Superior Court*, 264 Cal.App.2d 956, 959-961, where the plaintiff, although a substantial shareholder, was a minority one.

the extent of the proper percentage of its ultimate allowance, the judgment against Goodson and Hannam related to the fees to Mitchel, Silverburg & Knupp shall be reduced.

Further, by implication at least, interveners have applied for an allowance out of corporate assets for fees paid to their attorneys. The trial court should inquire into what proportion of their trial and appellate services fairly relates to the specified subjects and then should make an appropriate allowance and direction for payment.

Derivative moves of this type by the minority shareholders were an exigency to which Davis must be said to have submitted in allowing Custom to be organized and operated as part of the Custom plan.

5. *Reduction For Corporate Income Tax:*

Goodson and Hannam argue that the trial court should have taken into consideration that as to those parts of the surcharge damages which represent 60.67 percent of 35 percent of the damage item (representative of a supposed dividend or of an increase in equity position in Custom) there should be a reduction equivalent to 60.67 percent of what would have had to have gone out in corporate income taxes if the funds had never been disbursed by Custom and claimed as income tax deductions. The concept is that Davis should not recover more than he would have gotten if that had been the situation. One of the factors to consider is the possibility that Custom might be subjected to tax liability on an assumed intermediate recovery of the judgment amount going direct to Davis which would be taxable and that Custom would have to seek recovery from Goodson and Hannam, the parties who caused it

to make the improvident disbursements. We think that this would apply only when Davis made an actual recovery from Goodson and Hannam. Rather than reduce Davis' recovery by the estimated income tax figure and put Custom to the trouble of attempting recovery, if required, it seems more within the parameters of equity, more judicially efficient, and sufficiently practical to have the judgment declare that Davis hold as a constructive trustee for Custom (particularly with Davis in control) the necessary portion of any actual cash recovery from Goodson and Hannam to be applied to any Custom income tax liability which might eventuate.[76] It would seem more equitable for Davis rather than Goodson and Hannam to benefit from any decision of the taxing authorities not to make the claim.

6. *Managerial Salary Offset:*

Finally, there is one of the items which the trial court characterized as offsets to the surcharge judgment. Again court and counsel seem to have adopted a term for convenience.[77] This is the $98,500 set by the trial court as reasonable for managerial salaries for Good-

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[76]We appreciate that Custom might be said to have made an incorrect deduction for income tax purposes as to the full amount of any improper disbursement caused by Goodson and Hannam. However, it seems likely that another basis for deduction might be present even though Davis' derivative type claim did not seek full recovery for Custom.

[77]As we see it, the characterization is only apropos the $100,000 attorneys' fee figure. As to the managerial salaries, rather than a determination that Goodson and Hannam are liable for the full amount of salaries they caused Custom to pay to themselves to be offset by an amount determined to be what was reasonable for Custom to pay them, the determination should be that Goodson and Hannam's liability is for the excess they caused Custom to pay to themselves above what the trial court determined was reasonable. The distinction is fine (the end result being the same), but it does seem to be there and deserving of illumination, at least in a footnote.

son and Hannam.[78] A small quantity of evidence from Riskin, DeCastro and Goodson and Hannam was put on as to some of the nonlegal services rendered by Goodson and Hannam. However, no testimony or other evidence was presented on the reasonable value of the services or on any standard therefor in the corporate executive field.[79] The situation was different with respect to the value of Goodson and Hannam's legal services to Davis where both Page and Hochman testified.[80] The trial court could have gotten by without value testimony as to the legal services, since the law recognizes that the trial court itself has a degree of experience (which could be small or great) sufficient to allow it to pass on the issue. (*Elconin v. Yalen*, 208 Cal. 546, 549-550; *Excelsior Etc. School Dist. v. Lautrup*, 269 Cal.App.2d 434, 448; *Independent Iron Works, Inc. v. County of Tulare*, 207 Cal.App.2d 164, 167.) However, we know of no such rule in the corporate salary category. The same reason does not exist. Under the circumstances this particular part of the judgment (86.23 percent of $98,500 for a so-called offset) must be reversed and a remand made for the purpose of allowing the court to receive evidence on value and standards. In that connection, our viewpoint is that the burden of proof is on Davis to establish that the amount taken was not fair.

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[78]86.23 percent of this figure was used, in compatibility with the award.

[79]The trial court did not even seem to rely on the figures set by Judge Kurland which may or may not have been based on evidence or stipulation equivalent to evidence of value or standards.

[80]Hochman gave examples of both a flat and a contingent fee. The trial court obviously considered the former the appropriate vehicle. It adopted Hochman's lower range of $100,000.

*7. Disbursements to Denes*

The recovery stemming from the purchase of stock in and the loan of funds to Denes Co. is supportable on two theories. One is that of an action of a derivative nature[81] through Davis in his midtrial category of constructive shareholder, premised on the violation of an officer-director's duty to the corporation (*Schwab v. Schwab-Wilson Machine Corp.*, 13 Cal.App.2d 1, 3); the other is that of an action of a direct nature premised on the violation of an attorney's duty to his client.

The derivative claim was actionable because Goodson and Hannam's employment of their control and influence was not fully an "exercise [of] their powers in good faith," in the face of conflicting interests. (Corp. Code, § 820. See also 1 Ballantyne & Sterling, California Corporation Laws (4th ed.) Directors; Management § 78.01, pp. 139-141.) Such an officer-director cannot make a deal unfair to the corporation while using the influence and power of his position for his own interests. He is accountable for any disregard of his duty. (*Ibid.*, p. 142.)

At the time that Goodson and Hannam started putting Custom into the Denes venture they were subject to a conflict of interest. Goodson and Hannam (and May) had previously invested some of their own funds in

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[81]The usual requirement of establishing a referral to the board of directors and the reason for its failure to act may be omitted where it is obvious that there was an antagonistic board of directors. Also, the courts recognize as an alternative remedy to a conventional derivative suit, an action in equity when the cause of action is primarily on behalf of the corporation against the board of directors for wrongful dealing with the corporate property. (See *Winegand v. Atlantic Savings and Loan*, 1 Cal.3d 806, 818-819; *Reed v. Norman*, 152 Cal. App.2d 892, 898; Pomeroy, Equity Jurisdiction (5th ed.) § 1095.)

Denes. They were directors and officers thereof and dominant in its operations when they had Custom investing. Although Goodson and Hannam's investment was comparatively small in contrast with what became that of Custom (about 5 percent as compared to 70 percent), the trial court position may be justified on the approach that, at first, in light of the Denes enterprise being essentially an unknown quantity,[82] the Custom commitments were calculated by Goodson and Hannam to insure the value of their personal investment and a prolonged receipt of substantial salaries. This may have been enough for accountability.

The trial court probably would have been justified in taking the view point, as its findings suggest it did, that Goodson and Hannam acted despite the fact that any reasonable person would have had a great concern as to whether Denes would develop a profitable operation and be able to repay advances.

However, more serious involvement developed which gives firmer support to the ruling of the trial court. The circumstance evolved that Denes began to flounder financially threatening Goodson and Hannam's personal investment (and those of their client May and of some associates in their law firm, who in the meantime had acquired stock) and Goodson and Hannam's chances for lucrative salaries. The inference was available to the trial court that Goodson and Hannam caused Custom to pump more of its assets into Denes in an effort, in part, to rescue their own funds and positions. It is noteworthy that some of the loans to Denes were

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[82]The testimony of Goodson and Hannam indicated the Denes group had not taken formal shape. May testified that he knew that Denes had not been in business long and was not in good financial shape.

made after April 1966 when Keatinge made the overture to Goodson and Hannam on Davis' behalf. It also appears to be accepted that Denes was the only business to which Custom made loans. Finally, it is noted that no disclosure was made to Davis when the Denes stock purchases and loans were made.

The theory of recovery is that the wrongdoing officer-director should be responsible for the misapplication of corporate funds. The basis for giving personal recovery to Davis in a proportionate amount was previously discussed.

This segment of the judgment is also sustainable as a remedy for the violation by Goodson and Hannam of the high fiduciary obligation owed to Davis arising under the attorney and client relationship. The violation consisted of Goodson and Hannam's repudiation of their assurance to Davis that they would operate Custom in a manner calculated to aid the current functioning of the Custom Plan and to conserve its assets[28] and pointed to a disposition in the distant future under a windup-reverter operation. The trial court was entitled to view the heavy Denes investment as not supportive of a Davis oriented Custom Plan, but rather as a move to enhance the personal and adverse interests of Goodson and Hannam. It seems more than a coincidence that Goodson and Hannam's action put a very substantial amount of assets one step further removed from accessibility to Davis. Davis, under this theory, would have a personal right of recovery from Goodson and Hannam in the nature of indemnity for any loss he suffered because of their breach of professional duty to him.

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[28]Even May testified that the intention of Goodson and Hannam and himself was to let profits accumulate and for Goodson and Hannam to receive minimal salaries.

(*Redke v. Silvertrust, supra,* 6 Cal.3d 94, 100-101.) The appropriate measure of damages would be in the diminution of Davis' equity position in Custom, as constructive owner of 60 ⅔ percent of its shares by reason of the amount of funds lost by Custom in this venture.

The provision in the judgment for credit for 60 2/3 percent of any payments received by Custom from Potter-Englewood, of course, remains applicable.

## DAVIS' APPEAL AGAINST MAY

Davis appeals because the judgment did not impose a constructive trust for his benefit on May's Custom stock. The claim appears to be that May, through his Custom stock, became the transferee of trust property with constructive knowledge that the transfer was in breach of the trust or without giving any consideration therefor. In this instance, when Davis refers to trust property, he is not speaking about Custom stock. He must be alluding to things of value transferred by Davis (as himself or as Hydra) to Custom which he feels are traceable to the present equity interest in Custom which the 60 percent block stands for. Under the decision of the trial court there is just no logical basis for this contention. The Davis property referred to was never considered the subject of a trust. The only trust declared was a constructive one in rectification of a violation of an attorney's duty to his client and of which Goodson and Hannam's Custom stock was the corpus. Davis may have in mind that the attorney-client relationship is considered to be one of the trust relationships under Civil Code sections 2224 and 2243, but there was no corpus of that trust until Goodson and Hannam's stock became that in a sense when the

trial court imposed a constructive trust thereon as the appropriate consequence to Goodson and Hannam's breach of duty.

Although May affirmed that Goodson and Hannam had told him that Custom was needed to solve Davis' renegotiation problem, that Davis was going to provide the so-called start-up help, and that they were going to control and run Custom, this does not mean that he should have known of Goodson and Hannam's fraudulent intentions. Nor can May have been expected to appreciate the full nature and extent of the attorney's fiduciary duty to his client and what would amount to a breach thereof so that his association with awareness of Goodson ahd Hannam's conflicts of interest and some of their moves seemingly antagonistic to Davis' interests would involve him vicariously in the breach of trust. It might have been different had May been a lawyer. Nor was May's affiliation with Goodson and Hannam equivalent to that of the wife in *Atwood v. Elwood*, 132 Cal.App.2d 761, 767.

## INTERVENER'S PATENT ATTACK

Interveners contend that the trial court erred in foreclosing them, on behalf of Custom, from attacking the validity of the patent. They made an extensive offer of proof that the switch patent was invalid for a number of stated reasons. As we understand it, the offer does not relate to the other patents, no doubt because at suit time only the switch patent had any Custom production related to it. Interveners base their position on the case of *Lear v. Atkins*, 395 U.S. 653, 669-671 (overruling the part of *Automatic Radio v. Hazeltine*, 339 U.S. 827, supporting the doctrine of implied estoppel of a licensee to attack the validity of the licensed

patent). The indicated part of *Lear* stands for the proposition that as between the typical patent licensor and licensee, where the patent has issued at the time of licensing, the licensee is not estopped to attack the validity of the patent and is not required to pay royalties while he is doing so under the concept that there is an express or implied agreement that royalties are to be paid until such time as the patent is held invalid.[84]

We have concluded that the trial court was correct in its determination that *Lear* does not govern the instant situation. We do not believe that Custom's disentitlement to get out of its royalty obligation arises simply because it was a patent licensee under the old *Automatic Radio* doctrine. Preliminarily we observe, as we did previously, that the assignment transaction must be viewed as single in substance though trifurcated in form. After the constructive trust ruling of the trial court (which we are upholding), only the minority shareholders had the interest which would prompt action to have Custom present a *Lear* defense against the payment of royalties. There was no longer a four-square adversity between Davis and Custom. Moreover, it is significant that the Davis invention had already been licensed to Hydra which had developed the technique and know-how of producing products from it for industry. (Contractors to the government at that time.) From the standpoint of this aspect of the case, by implication, not only were the assignment of the patent interest and

[84]We are not concerned with the other segment of *Lear* which considers the problem there involved of the licensee's use for several years of the device ultimately patented as constituting a basis for resisting the payment of post patent royalties by attacking the validity of the patent. This is because the patent in our case issued practically contemporaneously with the assignment of the patent interest to Custom.

the headstart advantage inherent therein consideration for the royalty obligation, but so also was the furnishing by Davis to Custom of technical materials, scientific brain power, and production know-how (a recognized class of industrial property independent of a patent). Involved in the latter is the further headstart for the assignee of not having to develop such techniques itself and the cost of such development. (See Adelman, *An Anti-Trust Decision: Lear v. Atkins* (Jan. 1972) 58 A.B.A.J. 45-47, and Schneider, *Protecting Trade Secrets* (January/February 1972) Trial, pp. 55-57.)

Further Custom, the patent assignee, was formed specifically to be the assignee as a part of the Custom Plan for Davis' particular and personal reasons. There was no arms-length bargaining process between Davis and Custom. The value of an undivided one-half interest in Davis' patent was immaterial. Custom, essentially, was just a vehicle for the Custom Plan to save Hydra from renegotiation and to bring Davis capital gain income, as devised by Goodson and Hannam and as expressly recognized by May, and impliedly so, by the employee shareholders.[85] There was no implied representation of the validity of the patent, but Custom was to perform all lawful acts to sustain it as against third parties. As long as the governmental agencies were satisfied, the assignment met the purposes of the Custom Plan.[86] The record suggests that the minority

[85]There is no finding they did not. The only finding is that the minority shareholders acquired their stock without any notice of Davis' claim of right to a constructive trust and without any participation in or knowledge of Goodson and Hannam's professional derelictions.

[86]If, along the line, the government should have taken the position adverse to Davis and told him, because it felt that his patent was invalid, that it was going to consider that his royal-

(This footnote is continued on next page)

shareholders had the mental approach that there was available for them the opportunity to be profiting out of the scheme devised by Goodson and Hannam to aid their client, Davis; i.e., out of the functions of Custom as it implemented that scheme. Custom and its minority shareholders were in the position more of lacking standing to assert patent invalidity than of being estopped to do so.

Finally, and perhaps decisively on its own, in order for Custom to avoid its obligation to pay royalties to Davis, as its obligation was originally understood and as the contract has been interpreted by the court,[87] Custom (through the minority shareholders) would have to attack and establish the invalidity of all the patents to erase its royalty obligation, because royalty payments remain due as long as any one patent or improvement patent, even though narrowed in scope, remains effective, regardless of whether Custom is utilizing that one in its production (under the *Zenith-Automatic Radio* concept), as previously indicated.

## SPECIAL APPEALS

There is an appeal by the minority shareholders from that part of the order of June 4 ,1970, which says that no more attorneys' fees are to be paid from funds of Custom. They term this a protective appeal. It is questionable if the order was separately appealable. Anyway we consider it reviewable under the appeal from the judgment. The issue is met and resolved by

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ties were ordinary income and that Hydra and Custom were under common control, that might have meant that the reason for Custom and its operations had come to an end. Custom's dissolution, subject to fair treatment to the minority shareholders, might then have been in order.

[87]Meaning by the trial court to the extent affirmed by us.

our discussion on the main appeals. The order was sound as it related to the personal defenses of the minority shareholders. However, it should not now be considered appliable to the interveners to the extent that they should be permitted to obtain corporate assets to cover any fees allowed by the trial court to cover services in the limited areas indicated. The appeals from the order should be dismissed.

There is an appeal by the minority shareholders from the order of October 29, 1970, requiring them to withdraw a "Petition for Arrangment in Matter of Custom # 90764" under section 321 of the Bankruptcy Act. At least the notice of this appeal is part of the clerk's transcript. We are not sure whether it was intended that this be put before us. In any event, it is not pursued, so we do not treat with it. (*Title G. & T. Co. v. Fraternal Finance Co.*, 220 Cal. 362, 363; *Weiss v. Brentwood Sav. & Loan Assn.*, 4 Cal.App.3d 738, 746; *Southern Cal. Title Clearing Co. v. Laws*, 2 Cal.App. 3d 586, 591.)

## INTEREST

Interveners have raised the question of whether interest should have been allowed on the components of the royalty judgment against Custom. As premised on the 100 percent royalty base, the interest award probably was correct (*Esgro Central, Inc. v. General Ins. Co. of America*, 20 Cal.App.3d 1054, 1060-1061), but further determinations must be made at the trial level from the nature of which a decision on interest will be made. Thus it is premature for this court to make any pronouncement on the issue.

## DISPOSITION

In order to effectuate our holdings and to allow trial court reconsideration of the matters subject to remand the various segments of the judgment are affirmed and reversed (6 Witkin, Cal. Procedure (2d ed. 1971) Appeal, § 557, p. 4497) as follows:

Paragraph 1 of the judgment (impressing the constructive trust) is affirmed.

Paragraph 2 of the judgment (adjudicating Custom's royalty indebtedness to Davis) is reversed.

Paragraph 3 of the judgment (adjudicating Goodson and Hannam's indebtedness to Davis less offsets) is reversed.

Paragraph 4 of the judgment is affirmed.

Of Paragraph 5 of the judgment the following subparagraphs are reversed: (a), (b), (c), (d) and (h). There shall be struck from subparagraph (f), where it twice appears, the phrase: "based on 100% of its gross sales revenues or net profits (as the case may be)." As so altered, subparagraph (f) is affirmed. All other parts of paragraph 5 are affirmed.

To the extent that Paragraph 6 of the judgment decrees that the Custom stock standing of record in the name of Goodson and Hannam shall belong to Davis free and clear of any claims of Goodson and Hannam, it is affirmed; in all other respects Paragraph 6 is reversed.

Paragraph 7 of the judgment is reversed.

Paragraph 8 of the judgment is reversed.

Paragraph 9 of the judgment is reversed.

Paragraphs 10 and 11 of the judgment are affirmed.

Insofar as the judgment makes no provision for payment of some amount of attorneys' fees for interveners from the assets of Custom, it is reversed.

The trial court is directed to conduct further proceedings consistent with this opinion.

The appeals from the order of June 4, 1970, are dismissed.

The order for withdrawal of Petition for Arrangement is affirmed.

Davis is entitled to costs on appeal as against Goodson and Hannam.

May, in his individual capacity, is entitled to costs on appeal as against Davis.

All other parties, in whatever capacity, shall bear their own costs on appeal.

NOT FOR PUBLICATION.

Reppy, *J.*

We concur:

Aiso, *Acting P. J.*

Dunn, *J.*

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IN THE

# Supreme Court of the United States

October Term, 1972
Nos. 72-611 and 72-612

MARVIN GOODSON and WILLIAM E. HANNAM,
*Petitioners,*

*vs.*

ALLEN V. C. DAVIS, *et al.*,
*Respondents.*

THOMAS C. MAY, etc.,
*Petitioner,*

*vs.*

ALLEN V. C. DAVIS, *et al.*,
*Respondents.*

## Brief of Allen V. C. Davis in Opposition to Petitions for Certiorari.

Both of the above numbered petitions for certiorari arise out of a single lawsuit. The action was originally tried in the Los Angeles Superior Court, *sub nom. Davis v. Custom Component Switches, Inc., etc., et al.* The trial lasted 56 court days, and produced a record of more than 8,000 pages. A complex judgment, mostly favoring the plaintiff, Davis, was rendered by the Court. All of the litigants appealed from those portions of the judgment with which they were dissatisfied; and the appeals were consolidated for briefing, argument, and determination in the California Court of Appeal for the Second Appellate District, *sub nom.*

*Davis v. Goodson, et al.* On May 23, 1972, the Court of Appeal filed a single opinion, which was not certified for publication.* This opinion, which is reprinted in the appendices to the petitions, fills 91 printed pages. The Court of Appeal affirmed the judgment in Davis' favor in virtually all material respects, but remanded the cause to the trial court for further proceedings in connection with certain aspects of the judgment. The cause is now pending in the Los Angeles Superior Court, awaiting this limited retrial.

Because of the common factual nexus which underlies both petitions, Davis has undertaken to respond to them in a single brief.

## I.

## Petitioners Have Not Fairly Stated the Case on Which the California Courts Based Their Decision.

Three of the defendants below have petitioned this Court for certiorari, claiming that intervention by this Court is necessary to settle allegedly important questions of federal law, and to resolve an asserted conflict between the unpublished opinion below and the opinions of this Court in other cases.

The principal difficulty with the "Questions Presented" by petitioners is that they are not presented by the

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*Rule 976 of the California Rules of Court provides that an opinion of the Court of Appeal is to be published in the Official Reports only if a majority of the Court rendering the opinion, or the Supreme Court of California, certifies that it meets the standard for publication. That standard, which is set forth in the rule, provides that an opinion shall not be published unless it "(1) establishes a new rule of law or alters or modifies an existing rule, (2) involves a legal issue of continuing public interest, or (3) criticizes existing law." Manifestly, the Court of Appeal and the Supreme Court of California (to which the petitioners' claims have also been presented) did not believe that the opinion met the requisite standard.

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record. They are not based on the factual findings made by the trial court and approved by the Court of Appeal. They are based instead on a factual premise which the petitioners tried—unsuccessfully—to sell to the trial court; which they subsequently tried—again unsuccessfully—to sell to the Court of Appeal and the Supreme Court of California; and which they are now attempting to foist off on this Court as the foundation for their various claims of error.

The Court of Appeal elected to organize its factual recitals around its discussion of the several legal issues disposed of in the opinion, instead of following the usual course of prefacing the opinion with a summary of the facts. (Appendix, 2.) Seizing upon this circumstance, and apparently hoping that the sheer volume of the record would render it impenetrable to close scrutiny by this Court, the petitioners have attempted simply to ignore the case on which the courts below rendered their judgments, and have based their arguments on a misleading and distorted version of the facts.

All of the litigants testified at one time or another during the 56 days of trial, as did a variety of other witnesses called by the defense. More than 200 documentary exhibits were introduced into evidence and examined by the trial court. On the basis of this immense record, the trial judge made elaborate findings of fact, which constitute a detailed summary and distillation of the evidence, reflecting his resolution of all of the conflicts of testimony and inference which were urged by the parties, and disposing of all of the factual issues which were litigated in the case. These findings, together with the trial judge's conclusions of law and

judgment, may be found in the record. [C.T., Vol. 4, 829-872.]

After receiving voluminous briefs and extensive oral argument, the Court of Appeal took this case under submission for eight full months. After its deliberations, the Court of Appeal wrote a lengthy opinion, which reflects on its face that Court's careful and painstaking review of the record, and its sincere efforts to deal with each of the legal contentions advanced by the litigants.

While the Court of Appeal apparently believed that some of the trial judge's findings were "not fully supported or . . . extravagantly put," it concluded that the findings in this category were "not necessary to support the judgment." (Appendix, 6, fn. 2.) On the other hand, virtually all of the crucial findings required to sustain the judgment were found by the Court of Appeal to be supported by substantial evidence, and were accordingly upheld by that Court.

The trial court's judgment was, in most of its aspects, the only proper one he could have reached in the light of the facts he found to exist. The Court of Appeal recognized this to be true, and therefore affirmed the trial court's judgment in most material respects. Davis respectfully submits that there is nothing in this record which would require this Court to disturb the judgments of the courts below.

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## II.

## Statement of the Case on Which the Courts Below Rendered Judgment for Davis Against Goodson and Hannam.

### A. Goodson and Hannam Obtained Their Interest in Custom by Dubbing Their Client Davis.

In 1956, Davis was the sole owner and operator of a valuable and highly lucrative business, known as Hydra-Electric Company, which was manufacturing and selling several devices of Davis' invention. He sought the advice of Goodson and Hannam, lawyers and certified public accountants, about various business and tax problems then confronting him.

Goodson and Hannam devised a complicated plan for Davis, whereby his sole proprietorship would be organized into seven corporations, each of which was to perform some portion of the total activity theretofore performed by Davis as a sole proprietor. They told him that this would save him money by reducing his income taxes. Acting on this advice, Davis acquiesced in the arrangement; and Goodson and Hannam were retained to perform all the legal services involved in setting up the new companies, and thereafter they actively supervised the financial, accounting, and tax aspects of the new arrangement.

In early 1957, Davis inquired of Goodson and Hannam whether they thought he had a problem under the federal renegotiation laws, and if so, what ought to be done about it. Goodson and Hannam advised Davis that he had an urgent and pressing renegotiation problem, which in their opinion required drastic and immediate action. After pretending to explore a variety of alternative solutions, they persuaded Davis by various

fraudulent means and devices to adopt a complex arrangement of their devising, which has been referred to throughout this litigation as the Custom plan.

The gist of the Custom plan was that Davis was to transfer the most lucrative portions of his existing business to three corporations (the Custom companies) which were to be owned and controlled by Goodson and Hannam, and a client of theirs named May. This transfer was to be accomplished by having Davis persuade numerous customers of the Hydra-Electric Companies to cancel their pending purchase orders and reissue identical orders to the Custom companies; by instructing the sales representatives of Hydra-Electric to divert new purchase orders to the Custom companies; by transferring a substantial portion of the Hydra-Electric staff to the Custom payrolls; by furnishing to the Custom companies a complete supply of all of the tangible and intangible items necessary to the successful conduct of a going business, including inventory in various stages of completion, machinery, tooling, drawings and blueprints, qualification test data and reports, production and design know-how, and secret information, and sales and accounting materials; and by assigning to the Custom companies a one-half interest in each of the three inventions for which Davis then had patent applications on file.

As proposed by Goodson and Hannam, the Custom plan did not contemplate that they or their client (May) would personally pay anything at all to Davis in exchange for the transfer of this lucrative, going business. It did not contemplate that the Custom companies would pay Davis anything for the business either, except a fraction—less than 100%—of the profits on

the transferred business, plus a token amount for some of the tangible items to be transferred at the inception of the plan. Indeed, when the plan was originally implemented at the end of April, 1957, there was no writing, but only a handshake deal; there was no agreement as to what percentage of the profits of the Custom companies Davis would ultimately receive; and there was no agreement as to what amount the Hydra-Electric companies would receive in exchange for the tangible items transferred. The percentage was not specified until December of 1957, eight months after the plan went into operation; and nothing was paid to Davis on account of profits until about May of 1958, more than a year after the plan went into effect.

Goodson and Hannam have based their arguments throughout this litigation on the preposterous premise that Davis—claimed by them to be a cunning, shrewd, avaricious and sophisticated businessman—went into this vague, undocumented transaction with his own lawyers on an "arm's length" basis. However, the trial court concluded—in accordance with Davis' contentions—that Davis would never have gone along with the Custom plan, or parted with his business, if it were not for the fraud of Goodson and Hannam.

The judgments below turn on this crucial finding that Goodson and Hannam obtained their interest in Davis' business by defrauding him. The Court of Appeal succinctly summarized this essential fact as follows:

> ". . . Goodson and Hannam took advantage of the renegotiation adversity which beset Davis, of their position as his existing, trusted, and highly-rated attorneys called in to find a remedy for threatened harm, of their special and intimate

knowledge of the situation, and of the trust and confidence which Davis imposed in them, to get him, by making to him false representations and withholding essential advice, to adopt a remedial plan which they could and did manipulate to foster their own interests at his expense." (Appendix, 8.)

The opinion goes on to enumerate some, but by no means all, of the evidence which supports the trial court's finding that it was the actual and deliberate fraud of Goodson and Hannam which induced Davis to transfer his business to Custom. (Appendix, 10-17.)

Briefly, Goodson and Hannam induced Davis to go into the Custom plan by telling him (falsely) that, although they would have the record ownership and actual control of the Custom companies, they would always be managed for Davis' benefit. They told him (falsely) that, in order to avoid disastrous tax and renegotiation consequences, it was imperative that he not own any stock in Custom. Most important of all, Goodson and Hannam assured Davis that, if the surrounding circumstances should ever change, so as to make the continued operation of the Custom plan unsatisfactory or disadvantageous from Davis' standpoint, they could and would arrange to have the transferred business revert or "recircle" back to Davis; and they assured him that the inclusion of this reversion feature would not impair his right to whatever tax and renegotiation benefits the plan would otherwise afford. Actually, Goodson and Hannam had no intention of letting Davis' business revert to him at any time, but intended instead to keep it for themselves.

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From 1958 through 1965, Goodson and Hannam operated the Custom companies (which ultimately merged into Custom Component Switches, Inc.) and paid Davis a percentage of the profits. However, in the latter part of 1965, Goodson and Hannam recommended to Davis that he revise the Custom plan to provide for the termination of all profits-percentage payments within a few years. This was the first hint Davis had of Goodson's and Hannam's actual scheme, which was to "buy" his business with a fraction of his own profits, while retaining the rest of the profits and the residual value of the business for themselves. After consulting independent counsel, he gradually came to realize how badly he had been taken. Accordingly, Davis brought this action in September of 1966.

**B. Davis Has Never Asked the Court to Enforce an Illegal Agreement, or to Do Anything Which Would Contravene Federal Law or Policy; and the Courts Below Did Not Do So.**

Recognizing the lack of equity in their own position, Goodson and Hannam have elected to wrap themselves in the flag, and argue that this Court has no alternative but to leave them in possession of the business which they fraudulently obtained from their own client, allegedly in order to protect and advance the collection of the federal revenues.

They characterize Davis' claim (erroneously) as one for the specific enforcement of an agreement whereby they were to hold their ownership and control of the Custom companies as dummies for Davis, and whereby they were to turn such ownership and control over to him at his demand; and claim that the judgment below

accomplishes this result.* Although they make no assertion that such an agreement would be illegal *per se*, they now claim that the existence of such an agreement would be inconsistent with the tax and renegotiation positions they advised Davis to take over the years, and that its enforcement would thus somehow encourage the making of illegal contracts and violate public policy.

Of course, as the Court of Appeal correctly observed (fn. 22, Appendix, 30-34) Davis has never sought the specific enforcement of any agreement, legal or illegal. His claim was that he would never have gone into the Custom plan in the first place, if it were not for the false representations of Goodson and Hannam. Thus, he would not have gone into it, if he had known that Goodson and Hannam were planning to feather their own nests instead of acting for his benefit; and he would certainly never have "split his company" and given his business to them for nothing on a handshake basis, if they had not led him to believe that it would

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*Defendants are thus resting their case on the fallacy exposed by Justice Tobriner in his dissenting opinion in *Majewsky v. Empire Construction Co.*, 2 Cal. 3d 478, 85 Cal. Rptr. 819. Noting an apparent circularity in the result he was proposing in that case, he observed:

> "This sort of pseudo-circularity is inherent in the constructive trust remedy, and in any remedy which attempts to cure a wrong by placing the parties in the position they would have occupied, had the wrong not occurred. Take the simplest case for a constructive trust: defendant acquires plaintiff's property by fraud. To impose a constructive trust, we assume that defendant got title to plaintiff's property, but the imposition of a constructive trust restores title to plaintiff *ab initio*. The appearance of circularity of reasoning simply shows that the remedy has worked to obliterate the effect of the fraud or mistake." [2 Cal. 3d at 491, fn. 4.]

So here, the judgment restores Davis to some of the ownership and control he would have had in the absence of the fraud; but it certainly does not change the fact that, for fifteen years—until after the judgment became final in California—the ownership and control have actually been out of Davis' hands.

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and could legally revert to him at any time when a change in circumstances made the plan undesirable from Davis' standpoint. If they had told him then—as they now so vociferously argue—that the possibility of reversion would make the Custom plan unworkable, he would never have gone into it at all. (fn. 11, Appendix, 15-17.)

Accordingly, what Davis sought in this action—and what the trial court and Court of Appeal awarded him—was a judgment impressing a constructive trust on the business which Goodson and Hannam had obtained from him by fraud. As the Court of Appeal said, the conduct of Goodson and Hannam not only constituted a violation of their fiduciary obligations and the high standards of duty attendant on the relation of attorney and client, but also "amounted to fraud providing the trial court with the authority, in fact imposing upon it the obligation to declare a constructive trust" on that portion of Davis' property which they still retained. (Appendix, 18-19.)

Of course, the judgment stripping Goodson and Hannam of their ill-gotten gains, and partially restoring to Davis what they fraudulently obtained from him, does not affect Davis' obligations to the federal government. Whatever those obligations may be, Davis will undoubtedly be required to satisfy them. But that is a matter with which the courts below were not concerned, and with which this Court need not be concerned. The point is that, if Davis had not been fraudulently induced to go into the Custom plan, he would have retained the ownership of his business, and would have received all—rather than merely a fraction—of its profits over the years. To be sure, all of those

profits—like the partial payments he actually got under the Custom plan—would have been subject to the limitations and obligations imposed by the federal tax and renegotiation laws. It is useless to speculate whether he would have kept more or less of them if he had had honest lawyers and suitable tax and renegotiation planning. In any event, there are certainly no considerations of public policy which would justify a judgment in this matter which would leave Goodson and Hannam with the business they obtained by fraud from their own client.

*Cf. Redke v. Silvertrust*, 6 Cal. 3d 94, 98 Cal. Rptr. 293 (Cert. Den. April 3, 1972; .... U.S. ...., 31 L.Ed.2d 583).

## III.

## The Telephone Incident Does Not Affect the Judgment Against Goodson and Hannam.

### A. The Facts Relating to the Telephone Incident.

The record reflects that, on the evening of June 3, 1970, the trial judge had telephone conversations with Mr. Chodos (one of Davis' lawyers), and with Mr. Smith. Mr. Smith was then appearing of record for Custom Component Switches, Inc.; and was also acting on behalf of May, whose counsel of record, Mr. Beardsley, had unilaterally and precipitately left the trial two months earlier, on March 16. The following morning the trial judge announced for the record the substance of what had transpired the previous evening. Mr. Smith, however, took the stand and testified in somewhat more detail about his recollection of the conversation.

Smith testified that he had finished talking to the judge about 11:00 o'clock p.m., and that, as soon as he hung up the telephone, he called Goodson at home

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to dictate his account of the conversation with the judge into a recording machine. The tape was transcribed before court began the following morning, and Smith had a transcript with him when he took the stand.

It must be emphasized that, on May 26, 1970—a week before the telephone incident—the trial judge had made *and announced* his decision that Goodson and Hannam were liable to Davis for fraud. This decision was reflected in a minute order filed on May 26, 1970, and mailed to all counsel. [C.T., A-407.] As the Court of Appeal correctly holds in its opinion, this decision provided the trial judge, not only with the authority, but in fact with "the obligation to declare a constructive trust." (Appendix, 18-19.) The principal issue remaining for adjudication was whether the trust should extend to everything Goodson and Hannam had fraudulently obtained from Davis, including what they had subsequently transferred to May and the employee defendants; or whether the trust should be limited to the property still remaining in their hands.

At various times between the inception of the Custom Plan in 1957, and the time of trial in 1970, May and employee defendants had acquired interests of various kinds in the Custom companies from Goodson and Hannam. Some of these interests were acquired in good faith and for value, and without notice of Davis' claims. However, the record showed that Goodson and Hannam had attempted to transfer certain rights to May and the employee defendants *after* the filing of suit, and after everyone was fully advised of Davis' claims.

Thus, Goodson, Hannam, and May had entered into a stock purchase and sale agreement in 1964 respecting the shares of Custom, which provided in substance that, if any of them should undertake to transfer his shares, each of the others would have an option to buy the offered shares at book value (rather than fair market value), with the purchase price being paid 15% down, and the balance in installments at a nominal rate of interest over a four-year period. On October 13, 1966, after this suit was filed, and after May testified that he was fully aware of the suit and of the nature of Davis' claims [R.T., 455:24-457:14; 461:2-6], Goodson, Hannam, and May purported to amend the stock purchase agreement to invoke its provisions upon an involuntary transfer. The obvious purpose of this maneuver was to give May an installment-payment string on the Goodson-Hannam shares at book value if Davis should succeed in impressing them with a constructive trust.

The other agreement was dated February 10, 1967, and purported on its face to pledge the Custom shares standing of record in the names of Goodson and Hannam to May, to indemnify him from any detriment or loss he might suffer because of Davis' law suit. This action is identified in the agreement by case name and number.

According to Smith's account of his telephone conversation, the trial judge was concerned that, if he were to impress a trust in Davis' favor on the shares standing of record in the names of Goodson and Hannam, but at the same time sustain the stock rights granted to May in the two post-suit agreements above referred to, he would merely be giving Davis a judgment with one hand, and allowing May to take it away with the

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other. According to Smith, he and the trial judge referred to such a result as a "nugatory" judgment. Smith admitted that the trial judge had said he would be willing to receive any evidence or argument that Beardsley might have to offer on May's behalf in support of his post-suit stock rights. The trial judge confirmed on the record that he had indicated as much to Mr. Smith, and also told Mr. Beardsley that he had not made up his mind, and was willing to receive such evidence or argument, if Mr. Beardsley had any to offer. [R.T., 5130.]

Smith, however, testified that it was his "impression and recollection" that the trial judge had already made up his mind how he was going to rule, and that he was merely "going to protect the record by giving Mr. Beardsley an opportunity to present argument or evidence." Smith testified that it was his "conclusion, from what [the judge] said, and the way in which [he] said it, that any such argument or evidence [by Beardsley] would be futile." [R.T., 5100.]

For reasons which are not entirely clear from the opinion, the Court of Appeal accepted Smith's impressions and conclusions (instead of the trial judge's statements) and concluded that the telephone incident and its aftermath amounted to improper conduct, or at least apparently improper conduct, on the part of the trial judge; that the incident amounted to a violation of due process; and that it infected the trial judge's deliberations and determinations concerning the validity of all of the post-suit agreements relating to the stock rights of May and the employee defendants. Accordingly, the cause has been remanded for a further trial on the issues pertaining to these post-suit stock agreements.

**B. There Was Nothing Improper About the Trial Judge's Conduct.**

A careful review of the record reveals that the trial judge did nothing wrong, either in making the telephone calls, or in his handling of the proceedings on June 4 and thereafter. A detailed analysis of the record is set forth in Davis' petition for rehearing, filed in the Court of Appeal; and will not be repeated here. Suffice it to say that even Smith himself never indicated to the judge during the telephone conversation that he thought the judge was out of line. Instead, he undertook to chat with the judge about his (Smith's) family, and seized the opportunity to offer *ex parte* arguments about various matters then under consideration. So far from suggesting that it was improper for the judge to be giving him messages for transmission to Beardsley, Smith testified that, when the judge told him about his unsuccessful efforts to reach Beardsley, "I said that I would attempt to relay that message to Mr. Beardsley." [R.T., 5093:10-11.]

If, indeed, Smith had had any real idea that the judge's phone call to him was improper, he would undoubtedly have said so at the time, and insisted on deferring any further discussion until the following morning when all counsel were present. His subsequent assertion of impropriety was obviously the product of his conversation with Goodson, and his discussions with co-counsel for the defense.

If the record indicates that the judge was annoyed by Smith's about-face, and the ensuing defense maneuvers, it is respectfully submitted that his temporary annoyance was appropriate in the light of the provocation.

**C. The Judgment Against Goodson and Hannam Cannot Have Been Affected by the Telephone Incident.**

As noted above, the basic decision against Goodson and Hannam was made on May 26, 1970, a full week before the telephone incident. The balance of the judgment against them (at least to the extent it has been affirmed by the Court of Appeal) follows naturally and inevitably from the conclusion that Goodson and Hannam obtained their interest in Custom by defrauding Davis.

**D. Goodson and Hannam Have Waived Any Claim of Error, Including Federal Error, Based on the Telephone Incident, by Failing to Raise It in the Court of Appeal.**

The record shows that it was Mr. Westbrook, trial counsel for Goodson and Hannam, who originally made the motion for mistrial based on the telephone incident. [R.T., 5089.] This motion was denied by the trial court.

A notice of appeal was filed by Goodson and Hannam almost immediately after the judgment was entered. The record shows that Goodson and Hannam filed voluminous briefs in the Court of Appeal. The topical index of their opening brief consists of seven pages, listing literally dozens of alleged grounds for reversal. The reply brief they filed contains eight additional arguments. This does not even count the numerous contentions advanced by them as two of the "intervenors" on behalf of Custom. *Yet, nowhere in all this welter of argument did Goodson or Hannam ever suggest that the telephone incident had affected the fairness of the proceedings, or the correctness of the judgment rendered against them in the trial court.*

The rule in California is well settled:

> "The reviewing court is not required to make an independent, unassisted study of the record in search of error . . . It is entitled to the assistance of counsel. Accordingly, every brief should contain a legal argument with citation of authorities on the points made. If none is furnished on a particular point, the court may treat it as waived, and pass it without consideration."
>
> 6 Witkin, *California Procedure 2d* 4391 (Appeal, §425).

The rule has been applied where a point is raised in the briefs, but counsel fails to support it with argument. Obviously, the Court of Appeal cannot have been expected to find error where none was even asserted by Goodson and Hannam in their briefs.

Indeed, until the opinion was filed, the only litigant who complained about the telephone incident was May. Despite the fact that he probably waived his right to complain by his conduct in the trial court; and despite the fact that the order invalidating his post-suit stock rights was the only one which the trial court could have made as a matter of law (because he knew of Davis' claims when he obtained these rights, California Civil Code §2243; and because the transfer was in derogation of the court's jurisdiction in a pending action, California Civil Code §1908); the Court of Appeal gave him the further hearing he requested. It was never asked to give relief to the other defendants on the basis of this incident, apparently

because the other defendants did not consider themselves entitled to such relief.

Nor can Goodson and Hannam claim that they learned something from the opinion of the Court of Appeal which they did not know earlier. Their counsel moved for a mistrial at the time of the telephone incident, alleging that his clients had been or would somehow be prejudiced by it. After the final judgment was entered, however, he apparently recognized that the telephone incident had no effect on the trial or the judgment so far as Goodson and Hannam were concerned. The claim of procedural irregularity, which is now loudly and indignantly presented to this Court by Goodson and Hannam, is obviously the merest pretense, and a desperate attempt to grasp at straws in the hope of staving off the day of reckoning which has been so long delayed.

This Court has repeatedly held that a litigant's failure properly to raise and preserve an alleged federal question in accordance with state rules of procedure, at both the trial and appellate levels of state court proceedings, prevents him from seeking review of such a question here.

*Herndon v. Georgia*, 295 U.S. 441;
*Stembridge v. Georgia*, 343 U.S. 541;
*Beck v. Washington*, 369 U.S. 541, 553.

## IV.

**This Case Does Not Involve Any Federal Patent Issues.**

Petitioner May, in his capacity as a minority shareholder ("intervenor on behalf of Custom"), argues that, even if Davis is entitled to the ownership and control of 60⅔% of Custom's shares, he is not entitled to receive a percentage of its profits. This argument is based on the theory that Davis' switch patent is invalid, both because of lack of invention and because it was in public use or on sale more than one year prior to the date on which the patent was applied for. The defendant-intervenors,* including May, made an offer of proof on these points, which the trial court rejected.

The trouble with this entire contention is that a demonstration of invalidity of the switch patent, on whatever ground, would not affect Custom's obligations to pay Davis 65% of its profits. The trial court found that Custom's obligations to make such payments would not be affected by a determination that the switch patent was invalid. This is because the assignment of the switch patent was not the only consideration, or even the principal consideration, for Custom's obligation to make payments. For one thing, even the written agreements provide that Custom's obligation to make payments shall remain in effect so long as any of the three original patents or any improvement patent remains in effect. Secondly, the real basis for Custom's obligation to pay Davis 65% of its profits is that Custom's entire business (of which the switch patent was only a very small part) was transferred to it by Davis without any other consideration.

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*The other defendant-intervenors, although they pressed their contentions in the Court of Appeal and the California Supreme Court, have not sought certiorari as May has, and are accordingly named as respondents in the petitions.

As the opinion reflects, the Court of Appeal approved the trial court's reasoning and conclusions in this respect. (Appendix, 85-88.)

What all this means is that neither Custom, nor May as one of its minority shareholders, will benefit financially, even indirectly, even if May should somehow succeed in persuading the trial court that the switch patent is invalid. As he made no claim in the trial court, and makes no claim here, that the other patents or improvement patents are invalid, it is obvious that Custom's obligation to make payments will continue without diminution, whatever disposition might be made of their attack on the switch patent. Accordingly, the Court of Appeal was perfectly correct in holding that May had no standing to attack the switch patent.

Just as Goodson and Hannam have appointed themselves champions of the federal tax laws, May claims the right to vindicate an imagined federal policy to strike down federal patents whenever possible, relying on certain language taken out of context from *Lear v. Adkins*, 395 U.S. 653. However, it is only a few months ago that this Court reaffirmed its well settled rule that a litigant must have standing—"a personal stake in the outcome of the controversy"—before he can seek a judicial resolution of any question, even one involving the most important considerations of public interest and public policy.

*Sierra Club v. Morton*, 405 U.S. 727.

Certainly, there is nothing in this record to suggest that May—merely one of the minority shareholders of Custom—is entitled to waste additional months and years of court time in establishing the alleged invalidity of the switch patent, when he has no personal stake in the outcome.

## V.

## Conclusion.

Except for those minor points on which the matter has been remanded for further proceedings, the Court of Appeal concluded—after a careful review of the record—that the trial court's judgment was essentially correct; that it was supported by substantial evidence; and that it was based upon settled legal principles. There is no federal question involved in this case which either requires or justifies intervention by this Court. The petitions for certiorari should be denied.

Respectfully submitted,

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